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Municipal Legislative Commission

# Renew the Partnership:

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## A PRINCIPLED APPROACH TO FINANCING CITY GOVERNMENT

Agenda #1

### EXECUTIVE SUMMARY

A Report From the League of Minnesota Cities

#### FINANCING LOCAL GOVERNMENT TASK FORCE

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Association of Metropolitan Municipalities  
Coalition of Greater Minnesota Cities  
League of Minnesota Cities  
Minnesota Association of Small Cities  
Municipal Legislative Commission  
Range Association of Municipalities and Schools

**JANUARY 2005**

*The organizations represented on the Financing Local Government Task Force endorse the report and intend that it be a living document. As such, we pledge to work collaboratively going forward with the goal of encouraging and facilitating its recommendations.*

Full report available on the LMC web site at: [www.lmnc.org](http://www.lmnc.org)

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ACCOUNTABILITY • CERTAINTY • ADEQUACY • FLEXIBILITY • EQUITY

## Since the inception of the Minnesota

**Miracle in the early 1970s**, the local government finance system has been based on the belief that, except for the property tax, cities should have limited taxing authority. In return, state collected sales and income taxes have been distributed to cities generally based on need and their property tax capacity relative to other cities. The main goal of the Minnesota Miracle has been ensuring that Minnesotans receive adequate public services without paying inordinately different taxes, regardless of where they live.

At the conclusion of the 2004 legislative session, the LMC Board of Directors formed the Financing Local Government Task Force to review the state-local fiscal partnership. The Task Force concluded that the current system is not serving Minnesotans well or ensuring the state's competitiveness in an increasingly global economy. The Task Force made a number of recommendations with the intent of starting an ongoing dialogue about the state-local partnership. These recommendations are designed to serve as a roadmap to guide state policymakers and city officials in working together to reform the system over the next several years.

These recommendations are organized according to the Task Force's guiding principles for a viable state-city partnership:

- ACCOUNTABILITY
- CERTAINTY
- ADEQUACY
- FLEXIBILITY
- EQUITY

Some are closely integrated—a policy goal may be realized by more than one recommendation. Some options may bring about improvements for certain cities but create challenges for others. While some recommendations lend themselves to short-term implementation, others may require more in-depth planning and represent longer-run options.

## Recommendations

### ACCOUNTABILITY

*Cities believe that a viable partnership with the state requires cities and the state to communicate effectively with each other and with the public about their roles and responsibilities. Cities and the state must also exercise sound financial stewardship, including maximizing efficiencies in service delivery and other means of cost containment whenever possible.*

Elected officials must stand accountable for the decisions they make on behalf of citizens. Public agencies must be accountable to elected officials and the public. Less obviously, governments must be accountable to each other. When the state and federal governments impose mandates, the lines of accountability are blurred.

Cities are careful stewards of public resources. Minnesotans paid 15.6 percent of their personal income for state and local government in 2004, down from 17.4 percent in 1990. The city share fell from 3.5 percent to 3.1 percent over that time.

The Task Force agrees that state and local governments should work together to clarify their roles and responsibilities in providing, regulating, and paying for public services. It recommends the following:

- **Transform market value homestead credit reimbursement into a direct credit to individuals.** The market value homestead credit (MVHC) reimbursement structure undermines accountability by enabling the state to reduce or even eliminate the reimbursement to local governments, while preserving the credit to the homeowner. The structure adds unnecessary confusion, since cities whose reimbursements were cut in 2003 and 2004 were forced to certify property tax levies that were higher than what they actually received.
- **Create an advisory commission on intergovernmental relations.** A commission would provide an opportunity for legislators and administration officials to meet with their local partners to find the most effective and efficient ways to meet the needs of Minnesota residents and businesses. Participants would cooperatively and proactively address emerging issues, share creative solutions to public issues, and examine the long-term, broad cumulative impacts of policies.

- **Remove existing barriers to effectiveness.** The state should remove existing barriers to cities exploring opportunities for collaboration, sharing innovative practices, and applying new technologies. The state should allow local officials to implement smart ideas, such as posting notices on city web sites in lieu of publication and using design/build contracts.
- **Empower local decision-making on local budgets.** Artificial caps should be rejected. The state should authorize local officials to determine what revenues are necessary to provide the services demanded by citizens and businesses.

## CERTAINTY

*Cities need to have more certainty and predictability in all of their available revenue sources, including the property tax and the amount of funding they receive from local government aid (LGA) and similar programs. The current practice of almost annual adjustments to LGA and similar programs and the imposition of levy limits do not allow for prudent financial planning and decisions.*

The city budgeting process presents many challenges. Decision-makers strive to make wise spending choices, using resources efficiently and meeting service demands. When revenues upon which cities depend to deliver services are uncertain, budgeting becomes even more complicated. Periodic uncertainty in some budget years may encourage careful identification of spending priorities and exploration of new efficiencies. Significant, ongoing uncertainty about revenues, however, hampers cities' ability to effectively provide services to citizens.

In order to increase the certainty of revenues on which the state and cities rely, the Task Force recommends that the state:

- **Reform the state tax structure to increase stability of revenues.** The state should re-examine its revenue system and consider policy changes, such as reducing reliance on the corporate income and capital gains taxes, and broadening the sales tax base to include more goods and services.

- **Renew the state-local partnership.** The state should be a more reliable partner in providing public services and infrastructure. The annual uncertainty surrounding aid payments from the state should be remedied to enable cities to provide the critical services upon which citizens and businesses rely.

## ADEQUACY

*The revenue sources available to cities and the state must raise adequate funds to meet city needs, to fund mandates, and to maintain Minnesota's long-term competitiveness.*

To enable effective public services and a high quality of life, state and local governments need adequate revenues. Governments must carefully prioritize spending and work to maximize the effectiveness with which they spend public dollars. In tough times, less critical services must be curtailed. But when a lack of revenue results in basic services being cut, vital infrastructure improvements being delayed, and the state's long-term competitiveness being compromised, we must consider a different path.

The Task Force believes that the state should adequately fund its commitments to the public services upon which Minnesotans depend and recommends the following:

- **Fully fund local government aid (LGA).** LGA is the critical program that ensures all Minnesota communities can provide the services and infrastructure necessary to achieve economic prosperity. The program's funding was disproportionately cut in 2003, leaving property-poor and high-need communities struggling to provide necessary services.
- **Implement a metro-area sales tax to fund transportation and transit.** This would provide a critical, reliable, additional revenue source that would be more like the national norm of paying for regional transit through a regional tax source.
- **Increase state revenues.** The state should increase general revenues, while being mindful of impacts on our most vulnerable citizens, to preserve and enhance the services upon which our future depends. Further cuts to aids for cities to fund education or other needs are unacceptable.

## FLEXIBILITY

*As cities have become increasingly diverse in their characteristics, a "one-size-fits-all" system that limits all cities to the property tax as the major, non-state aid revenue source is increasingly unworkable. Some cities have sufficient property tax base to sustain an adequate service level, but many do not. Cities should have greater access to other tax and revenue sources than currently permitted.*

Cities face a wide range of unique circumstances involving their tax base, the mix of revenues on which they depend, where users of their services come from, and their population makeup. Cities also vary in which services they are responsible for financing and delivering. We believe that a full toolkit of revenue options is important so that city officials can best link users of a service with those who pay for it, provide an adequate amount of basic services despite cities' varying ability to pay, and work to ensure stability of city revenues during economic downturns by relying on several sources of funding.

In order to enhance the flexibility of cities in funding services, the Task Force recommends the state:

- **Support revenue diversification.** The state should recognize the diverse circumstances facing cities, and allow them to choose from a wider variety of tools to finance city services and infrastructure. These would include a local sales tax for capital projects; street and other utilities; impact fees; and mechanisms to capture revenues from all users.
- **Enhance local revenue and spending autonomy.** The state should not impose artificial caps on cities, but should increase the autonomy given to city officials to make revenue-raising decisions. Cities should have authority to make spending decisions that best meet the needs of their communities.

## EQUITY

*All citizens should receive adequate levels of municipal services at relatively similar levels of taxation. This means the state should provide financial assistance to cities that have high needs, low fiscal capacity, or both.*

Of the principles discussed in the report, equity may be the hardest to measure and the most subjective—what appears equitable to one person may seem patently unfair to another. Historically, some of the thorniest issues regarding our state-local finance system revolve around differing interpretations of equity. The Minnesota Miracle reforms addressed equity issues by creating a system of centralized revenue collection and decentralized service delivery. At that time, the state initiated its first sales tax to fund a complex new system of inter-governmental aids, including LGA.

The Legislature must continually monitor the system for tax burden equity, considering both ability to pay and to whom the benefits accrue. The Task Force recommends that the state do the following in order to enhance the equity of our state-local finance system:

- **Mitigate excessive property tax burdens.** The state should fully fund the LGA program. The state should target more property tax relief to individuals through the circuit breaker and related programs when taxes increase rapidly or when burdens are excessive relative to income. In addition, the state should provide adequate tax relief to all types of property in low property-wealth and high-need communities.
- **Connect the costs and benefits for services.** The state should provide cities with tools that align service costs with service beneficiaries. For example, a local sales tax may be a useful tool for a regional center to capture revenues from commuters, tourists, and tax-exempt property that place a burden on its infrastructure. When charging users is not feasible or appropriate, the state should adequately compensate communities for overburden through LGA or other mechanisms.



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**Renew the Partnership:  
A Principled Approach to Financing City Government**

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*The League of Minnesota Cities is a non-profit, membership organization dedicated to helping cities throughout Minnesota build quality communities by providing effective advocacy, expert analysis, trusted guidance, and collective action. The League serves its members through advocacy, education and training, policy development, risk management, and other services.*



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# Executive Summary

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## RECOMMENDATIONS

**Accountability**—*Cities believe that a viable partnership with the state requires cities and the state to communicate effectively with each other and with the public about their roles and responsibilities. Cities and the state must also exercise sound financial stewardship, including maximizing efficiencies in service delivery and other means of cost containment whenever possible.*

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Of the principles discussed in the report, equity may be the hardest to measure and the most subjective—what appears equitable to one person may seem patently unfair to another. Historically, some of the thorniest issues regarding our state-local finance system revolve around differing interpretations of equity. The Minnesota Miracle reforms addressed equity issues by creating a system of centralized revenue collection and decentralized service delivery. At that time, the state initiated its first sales tax to fund a complex new system of inter-governmental aids, including LGA.

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# Introduction

Since the inception of the Minnesota Miracle in the early 1970s, the local government finance system has been based on the belief that, except for the property tax, cities should have limited taxing authority. In return, state collected sales and income tax revenues have been distributed to cities generally based on need and their property tax capacity relative to other cities. The goal has been to ensure residents receive adequate services without paying inordinately different taxes, regardless of where they are located.

In the last five years alone, state aid to cities has fallen by more than 28 percent when measured on a per capita basis. This reduction appears to have been partly due to the state's budget deficit, but also to a changing philosophy among some influential state government leaders about the state's role in financing local government services. Moreover, changes to the system now occur with increasing frequency creating instability and unpredictability.

Cities throughout the state are becoming more reliant on their own residential property tax base to fund services. State aid cuts, for example, have increased cities' reliance on property taxes. Further, class rate compression and phasing out the limited market value program have shifted more of the property tax burden onto homestead property. This has resulted in reduction of services in some instances and increased the tax rate disparity among many cities. Left unaddressed, the underlying premise of the Minnesota Miracle that all citizens should receive adequate levels of municipal services at relatively similar levels of taxation will be unachievable.

At the conclusion of the 2004 legislative session, the League of Minnesota Cities (LMC) Board of Directors formed the Financing Local Government Task Force (see Appendix A for the full text of the Task Force's Statement of Purpose). During the session, it was clear city officials held conflicting opinions about the most effective and equitable way to restore funding to the local government aid (LGA) program, most notably concerning proposals to utilize programs such as the market value homestead credit (MVHC) and transit aid for that purpose. As members of the Task Force, we came together despite these different opinions in order to identify what we, as a community of cities, have in common.

As that process evolved, we defined policy options for renewing the state-local partnership that we could all support. Recommendations to the state form the basis of this report and are intended to start an ongoing dialogue about the state-local partnership. The recommendations are designed to serve as a roadmap to guide state policy-makers and city officials in working together to reform the system over the next several years.

These recommendations are organized according to the guiding principles for a viable state-city partnership in the Task Force's Statement of Purpose: **Accountability, Certainty, Adequacy, Flexibility, and Equity.**

1. **Accountability**—Cities believe that a viable partnership with the state requires cities and the state to communicate effectively with each other and with the public about their roles and responsibilities. Cities and the state must also exercise sound financial stewardship, including maximizing efficiencies in service delivery and other means of cost containment whenever possible.
2. **Certainty**—Cities need to have more certainty and predictability in all of their available revenue sources, including the property tax and the amount of funding they receive from local government aid (LGA) and similar programs. The current practice of almost annual adjustments to LGA and similar programs and the imposition of levy limits do not allow for prudent financial planning and decisions.
3. **Adequacy**—The revenue sources available to cities and the state must raise adequate funds to meet city needs, to fund mandates, and to maintain Minnesota's long-term competitiveness.
4. **Flexibility**—As cities have become increasingly diverse in their characteristics, a "one-size-fits-all" system that limits all cities to the property tax as the major, non-state aid revenue source is increasingly unworkable. Some cities have sufficient property tax base to sustain an adequate service level, but many do not. Cities should have greater access to other tax and revenue sources than currently permitted.
5. **Equity**—All citizens should receive adequate levels of municipal services at relatively similar levels of taxation. This means that the state should provide financial assistance to cities that have high needs, low fiscal capacity, or both.

While not all Task Force members or the groups that we represent see all of the issues in the same way or agree on all of the ramifications of certain policies, we did come to an agreement on the recommendations described in this report. We thoughtfully weighed the consequences of a wide variety of policy options to address the problems in the current state-local fiscal system, and came to a consensus on the final list of recommendations.

The report recommendations should serve as a roadmap to guide city officials and state policy-makers in reforming the state-city relationship over the next several years. We do not think that the current system is serving Minnesotans well or ensuring our state's competitiveness in an increasingly global economy. The impacts of the state and city budget cuts have been felt most keenly by the most vulnerable of our cities and citizens, but the impacts may be more broadly felt as the state deals with another deficit for the next biennium.

**The report recommendations should serve as a roadmap to guide city officials and state policy-makers in reforming the state-city relationship over the next several years.**

**We hope that this report begins a dialogue about how to finance the city services on which citizens and businesses rely in ways characterized by accountability, certainty, adequacy, flexibility, and equity.**

Our recommendations are focused on the state-city financial relationship. We do not claim expertise in other parts of the state budget or in the financing of other local governments. But we believe that there are real fiscal challenges in these areas as well. While our recommendations include an increase in state aid to cities, we believe that this policy change should not come at the expense of other local governments or other parts of the state budget.

We hope that this report begins a dialogue about how to finance the city services on which citizens and businesses rely in ways characterized by accountability, certainty, adequacy, flexibility, and equity. We believe that several of the recommendations are achievable in the short term, with commitment from the state and cities to work together and openly discuss the issues. Other recommendations are more long-term goals for how the state-local fiscal partnership should evolve into the future.

The following table shows the estimated total amount of state aid to local governments in fiscal year 2005. The total amount of state aid is estimated to be \$1.2 billion, which is a decrease of \$100 million from the total amount of state aid in fiscal year 2004. The decrease is due to a decrease in the amount of state aid for the state's general fund, which is estimated to be \$800 million in fiscal year 2005, compared to \$850 million in fiscal year 2004. The amount of state aid for the state's general fund is estimated to be \$800 million in fiscal year 2005, compared to \$850 million in fiscal year 2004. The amount of state aid for the state's general fund is estimated to be \$800 million in fiscal year 2005, compared to \$850 million in fiscal year 2004.

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# Chapter One: Accountability

**Accountability**—Cities believe that a viable partnership with the state requires cities and the state to communicate effectively with each other and with the public about their roles and responsibilities. Cities and the state must also exercise sound financial stewardship, including maximizing efficiencies in service delivery and other means of cost containment whenever possible.

Good government requires accountability. Elected officials must stand accountable for the decisions they make on behalf of citizens. Public agencies must be accountable to elected officials and the public. Less obviously, governments must be accountable to each other. Perhaps nothing frustrates a citizen more than hearing from a government official that the citizen's concern is "somebody else's fault" or "somebody else's problem." Accountability for public services can be murky when a service is provided by one level of government but funded and/or mandated by another, or when a local government is restricted in its ability to fund a service that is mandated by the state or demanded by citizens. Another example of accountability not being clear is the state imposing a sales tax on certain local government purchases. The sales tax impacts the cost of providing city services.

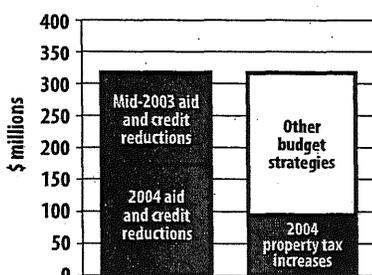
When the state and federal governments impose mandates, the lines of accountability are blurred. State officials often express frustration with federal mandates. Similarly, state and federal actions can inhibit city officials' ability to find innovative solutions to local problems. Local elected officials must have the authority and tools necessary to take actions in the public's interest without unnecessary restrictions from the state or federal governments.

Citizens generally have confidence in their local government officials. Yet to hear some pundits tell it, cities are inefficient bureaucracies that love nothing more than to raise taxes. The reality, which city officials tirelessly point out, is much more encouraging:

- **Cities are careful stewards of public resources.** Real city revenues per capita declined from 1990 to 2003, the last year for which audited statewide data are available. The dramatic cuts in city aids in 2003 and 2004, combined with extremely tight property tax levy limits, resulted in an overall reduction in city revenues from 2002 to 2003, and likely have resulted in unusually modest revenue increases in 2004. City officials dealt with the cuts to local government aid (LGA) responsibly, relying on property taxes to cover only a fraction of the cuts and employing other strategies, such as new efficiencies (see Chart 1A).
- **City government, like Minnesota government overall, is more affordable to taxpayers today than it was in 1990.** According to the Minnesota Department of Finance's Price of Government estimates, Minnesotans are paying 15.6 percent of their personal income for state and local government in 2004, compared to 17.4 percent in 1990. Cities' estimated share of this amount (including state and

A 2000 NPR/Kaiser Family Foundation/Kennedy School of Government poll found that roughly two-thirds of respondents (65 percent) indicated that they have confidence in their local governments solving problems that they set out to solve.

**CHART 1A:**  
2003 AND 2004 AID CUTS  
AND CITY RESPONSE



local transfers) has declined from 3.5 percent to 3.1 percent over the same time.

- **Cities' good practices build accountability and trust.** In many ways, cities are models of public budgeting and decision-making. Cities balance their budgets every year, have open and accessible budget processes, and provide many opportunities and methods for meaningful public input.
- **Cities constantly strive for new innovations and efficiencies.** In a recent LMC survey, 275 Minnesota cities cited almost 1,700 cooperative agreements between their city and other government or non-governmental entities. One-third of cities that responded to the survey reported that in 2003 they increased their efficiency through contracting out services, increasing productivity, and/or expanding cooperative agreements or other cost-sharing plans. (For more information on the cooperative agreements reported in the survey, see the *State of the Cities Report 2004*, available in the Policy Research Division section of the LMC web site at: [www.lmnc.org](http://www.lmnc.org).)

## RECOMMENDATIONS

We believe that state and local governments should work together to clarify their roles and responsibilities in providing, regulating, and paying for public services. To improve accountability, we recommend the following:

**Transform MVHC into a direct credit to individuals.** Currently, the market value homestead credit (MVHC) program provides tax relief to homestead property by reducing the homeowner's property tax bill. Local units of government are subsequently compensated by the state for the loss of property tax revenue due to the credit. The MVHC reimbursement structure undermines accountability in a number of ways, most directly by enabling the state to reduce or even eliminate the reimbursement to local units of government while preserving the benefit of the credit to the homeowner. The structure interferes with local officials' accountability to the taxpayers and adds unnecessary confusion, since cities whose reimbursements were cut in 2003 and 2004 were forced to certify a property tax levy amount that was higher than the amount of revenues the city actually received from the property tax system.

**Create an advisory commission on intergovernmental relations.** To ensure the most effective government for citizens, state lawmaking and rulemaking must be made openly with the broadest possible input. To this end, we recommend improving communication between state and local officials through the creation of an advisory commission on intergovernmental relations (ACIR). An advisory commission would provide an opportunity for legislators and administration officials to meet with their local partners to address ways to work together to find the most effective and efficient ways to meet the needs of Minnesota's residents and businesses. Whereas the legislative process generally deals with narrow issues of immediate concern, an ACIR would provide

**We believe that state and local governments should work together to clarify their roles and responsibilities in providing, regulating, and paying for public services.**

a forum to examine the combined impacts of state and federal actions and demographic changes over the long term. The commission would cooperatively address emerging issues in a proactive manner, thoroughly explore the best creative solutions to public issues, and minimize the unintended negative impacts of mandates.

***Remove existing barriers to effectiveness.*** Cities are continually looking for ways to more effectively deliver services demanded by citizens and businesses by exploring new opportunities for collaboration and cooperation, sharing innovative practices, and applying new technologies. The state should remove existing barriers to local effectiveness to allow local elected officials to implement smart ideas. Some examples include:

- Allow greater use of design/build contracts for construction projects.
- Allow greater use of city web sites and other communications vehicles to disseminate some information currently required to be published in newspapers.
- Trust local elected officials to determine fair compensation for their top employees. Many of the best and brightest public administrators and other professional employees like engineers are leaving public service for employment in other states or in the private sector. Local governments receive very few applications from non-Minnesota residents for these kinds of job vacancies. The state should eliminate the salary cap for government employees.

***Empower local decision-making on local budgets.*** Local officials are elected to determine the scope and level of local services. The state should authorize local officials to determine what revenues are necessary to provide the services demanded by citizens and businesses. State-imposed artificial caps that don't account for local circumstances and second-guess the judgment of local elected officials should be rejected.

The following table shows the estimated total amount of state aid to local governments in fiscal year 2005, broken down by type of aid. The total amount of state aid is estimated to be \$1.2 billion, or 0.2 percent of the state's general fund. The largest portion of the aid is for general assistance, which is estimated to be \$600 million, or 50 percent of the total. Other significant categories include aid for education, which is estimated to be \$300 million, or 25 percent of the total, and aid for health care, which is estimated to be \$200 million, or 17 percent of the total.

The table also shows the estimated amount of state aid to local governments in fiscal year 2004, for comparison. The total amount of state aid in 2004 is estimated to be \$1.1 billion, or 0.2 percent of the state's general fund. The largest portion of the aid is for general assistance, which is estimated to be \$550 million, or 50 percent of the total. Other significant categories include aid for education, which is estimated to be \$250 million, or 23 percent of the total, and aid for health care, which is estimated to be \$150 million, or 14 percent of the total.

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## Chapter Two: Certainty

***Certainty**—Cities need to have more certainty and predictability in all of their available revenue sources, including the property tax and the amount of funding they receive from local government aid (LGA) and similar programs. The current practice of almost annual adjustments to LGA and similar programs and the imposition of levy limits do not allow for prudent financial planning and decisions.*

**The city budgeting process presents many challenges. Decision-makers strive to use resources efficiently, make wise spending decisions, and meet the demands for services.**

The city budgeting process presents many challenges. Decision-makers strive to use resources efficiently, make wise spending decisions, and meet the demands for services. When revenues upon which cities depend to deliver those services are uncertain, budgeting becomes even more complicated. While aid and credit cuts have the most dramatic impact on total revenues, economic downturns can also bring about shortfalls in other revenue sources such as fees and charges.

Volatility in state aids and credits causes cities to struggle to ensure maintenance of basic services like police and fire protection. It is difficult to plan for large capital projects that will have costs spread over many years, such as major street improvements or additional fire stations, when future revenues are uncertain. Volatility in city revenues also makes decisions about operating budgets, such as whether or not to hire additional police officers, more difficult. Cities have had to consider several budget scenarios, each with different amounts of state aid and credit. This added complexity consumes time, money, is an inefficient use of staff resources, and makes the city budgeting process more confusing for citizens.

Periodic uncertainty in some budget years may encourage careful identification of spending priorities and exploration of new ways of doing things. Significant, ongoing uncertainty about revenues as currently exists, however, hampers cities' ability to effectively provide services to citizens. In mid-2004, the governor acknowledged the challenges that uncertainty about aid payments presents to cities. Cities were unsure how much LGA to budget for because of a drafting error that would have significantly changed the aid distribution for some cities. After much debate, the governor directed the state to distribute the 2005 payments according to the intent of the law and not according to the erroneously written law.

### STATE-LOCAL FISCAL PARTNERSHIP: A LITTLE HISTORY

We believe that the state is failing to fulfill its long-established commitment to cities. The state-local partnership to finance the basic services on which Minnesotans depend was formalized in the Minnesota Miracle reforms of 1967 through 1971. These reforms established the state sales tax in order to provide property tax relief to taxpayers and to enable local governments to provide basic services despite differences in property tax base. This policy was reaffirmed with the creation of the Local Government Trust Fund in 1992, which increased the state sales tax and dedicated a portion of the sales tax

revenues to several local government aid programs. The Trust Fund was eliminated in 1996 and the sales tax revenues were redirected to the general fund.

Mid-year cuts in 2003 to LGA and the market value homestead credit (MVHC) reimbursement, revision of the LGA distribution formulae, and the ongoing pressures of state budget deficits have all recently served to dramatically reduce the certainty with which cities view their revenues from the state. The mid-year cuts to 2003 LGA and MVHC reimbursements left cities scrambling to make adjustments halfway through their budget year. Levy limits imposed on cities over 2,500 population meant these cities could not fully replace the cuts with property taxes. In efforts to cope with the 2003 cuts, cities postponed spending for capital improvements, drew down budget reserves, increased fees and charges, and made service reductions.

For some cities, the 2003 aid cuts were particularly challenging. In 2002, these cities saw LGA increases to balance the tax relief provided as part of the 2001 reforms. Along with these aid changes, however, strict levy limits were imposed. The levy limits forced these cities to lower their levies because of the LGA infusion and become more heavily dependent on LGA. When LGA was subsequently cut during the 2003 budget year, these cities were in an especially difficult position to balance their budgets.

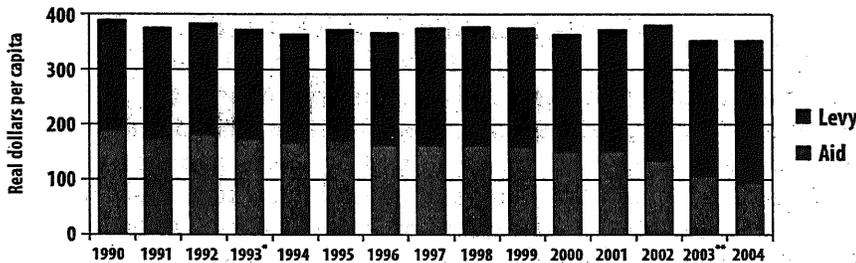
The significant reform to the LGA distribution formulae passed by the 2003 Legislature will increase the uncertainty of future aid payment amounts. As a result of the new formulae, the volatility of the distribution has become a much more significant issue. Cities that receive LGA can expect the year-to-year change in aid to be substantially more than under the old LGA program. This volatility will make long-range budgeting more difficult and may create more confusion among citizens about how the program works.

**STATE REVENUE INSTABILITY IMPACTS AIDS TO CITIES**

The certainty of state aids and credits is clearly related to the certainty of state revenues. Recessions in the early 1980s, early 1990s, and early 2000s all resulted in significant cuts to state aids. Chart 2A shows that over the last 15 years, cuts in aids and the effects of inflation and

Reasons for increased volatility of LGA include: elimination of the grandfathered aid base, a change in the factors used to calculate need for cities over 2,500 population, elimination of the automatic inflationary increase, and the elimination of the special caps on First Class cities. For a discussion of LGA volatility, see the in-depth policy analysis, "LGA Volatility: New system yields bigger year-to-year aid changes and less accurate aid estimates," by LMC Policy Research Manager Eric Willette, available in the Policy Research Division section of the LMC web site at: [www.lmnc.org](http://www.lmnc.org).

**CHART 2A : CITY PROPERTY TAXES AND STATE AIDS 1990-2004**



\*In 1992, the Legislature imposed the sales tax on city purchases.  
 \*\*In 2002, the Legislature eliminated the Tax Increment Financing (TIF) grant pool, a \$200 million loss over four years.

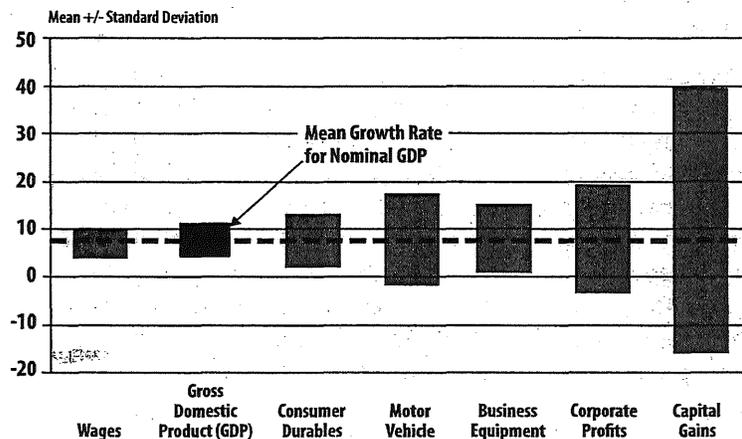
population growth have made cities much more reliant on property taxes. Other legislative changes that have impacted cities' budgets include the sales tax on city government purchases (1992) and the elimination of the tax increment financing (TIF) grant pool (2002).

With the state facing a projected 2005-06 deficit of \$1 billion, cities overall remain concerned about further budget upheaval from additional cuts to the LGA and MVHC programs. Over the last five years, the state's revenue picture has gone from one of surplus to one of repeated deficits. While the economy, international turmoil, and the Dot-Com burst in the stock market all contributed to the souring of Minnesota's revenue projections, there are also structural causes. The state's revenues are in part more volatile because of the increasing volatility in the income tax, a major source of revenue. Income has become more variable due to the growing use of commissions, bonuses, and other rewards for performance. During boom times, workers receive more of these rewards. When the economy sours, they receive less. Income is also made less stable due to the growth in investment income as a portion of total income. Investment income is closely tied to the business cycle. Capital gains are the most volatile source of income (see Chart 2B).

#### CHART 2B:

#### VOLATILITY IN STATE TAXES

Minnesota's tax base is more volatile than nominal GDP



Reprinted with permission by the Citizens League, "Let's Get Minnesota's Tax System off the Rollercoaster," by Tom Stinson and Jeremy Prahm, Minnesota Journal, August 2004.

## RECOMMENDATIONS

In order to increase the certainty of revenues on which the state and cities rely, we recommend the state:

**Reform state tax structure to increase stability of revenues.** The state should re-examine its revenue system and make policy changes to increase the year-to-year stability of revenues. A recent article by State Economist Tom Stinson and Jeremy Prahm included the following policy options to achieve this goal<sup>1</sup>:

- **Reduce reliance on the corporate income tax and increase the state property tax on commercial/industrial property.** This could be a revenue-neutral change, meaning that the general fund does not see an increase or decrease in revenues. It could, however, increase stability since corporate income is highly volatile.
- **Increase the tax rate for those earners in the top tax bracket, while simultaneously lowering the tax on capital gains.** Again, the change could be revenue neutral, but state revenues would be more stable with less reliance on capital gains revenue.
- **Apply the sales tax to more necessities in order to better align the sales tax with today's service-driven economy and lower the sales tax rate.** This would help to avoid declines in sales tax revenues during downturns when a greater share of consumer dollars is spent on these items. A new refundable credit program directed to low-income households could help keep the sales tax burden for those households relatively constant even with the changes.

Each of the policies outlined in Stinson and Prahm's article would increase the certainty of state revenues from year to year and, in turn, increase the certainty with which cities view their sources of revenue that come from the state. While stability is not the only important issue in regard to state revenues and aids to cities, it is a critical one. A blue-ribbon task force of state and local officials, business representatives, and experts in tax policy should be convened to examine the stability of the state's tax structure and to explore policy options such as those described above.

**Renew the state-local partnership.** We believe that the state should be a more reliable partner in providing public services and infrastructure to residents and businesses. The state should consistently and fully fund LGA. One possible way to do this is through a re-dedication of state sales tax revenues. The annual uncertainty surrounding aid payments from the state should be remedied to enable all cities to provide the critical services upon which citizens and businesses rely. The state should also authorize more revenue options for cities that are able to increase their financial independence (see Chapter 4: Flexibility). These policy options are discussed in more detail in other chapters of this report.

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#### Endnotes

<sup>1</sup> Stinson, Thomas, and Jeremy Prahm. "Let's Get Minnesota's Tax System Off the Rollercoaster," *Minnesota Journal*, August 2004.

## Chapter Three: Adequacy

**Adequacy**—The revenue sources available to cities and the state must raise adequate funds to meet city needs, to fund mandates, and to maintain Minnesota's long-term competitiveness.

To enable effective public services and our high quality of life, our state and local governments need adequate revenues. Governments must carefully prioritize spending and work to maximize the effectiveness with which they spend public dollars. In tough times, less critical services must be curtailed. But when a lack of revenue results in basic services being cut, when vital infrastructure improvements are delayed, and when our state's long-term competitiveness is compromised, we must consider a different path.

### CITIES ARE COPING WITH INADEQUATE REVENUES

Cuts to city aids and credit reimbursements were a disproportionate share of the state's most recent budget-balancing actions. The first round of cuts occurred in the middle of cities' 2003 budget year. While the combined reduction in aids and credits for 2003 and 2004 exceeded \$300 million, cities increased their property tax levies in 2004 by only \$90 million, scarcely more than a typical year's increase to cover inflation and growth (see also Chart 1A, page 5). While levy limits were a factor in keeping down property tax increases, many mayors and city councils determined that they simply could not increase the property tax burden in an amount necessary to cover the full impact of aid cuts.

It would be easy to say, as some pundits do, that cities should adjust to the state aid and credit reductions by cutting discretionary services and finding new efficiencies rather than increasing revenues. In reality, cities have done these things and much more. October 2004 employment estimates from the Minnesota Department of Employment and Economic Development show that non-school local governments, including cities, reduced their workforce by 4.6 percent, or about 7,000 workers, between September 2002 and September 2004. An LMC survey of city officials conducted in the fall of 2003 found that cities have adjusted their budgets with a multi-pronged approach that includes service cuts, workforce reductions, new efficiencies and drawing down reserves, as well as revenue increases (see Table 3A). The survey also indicated that more cuts were in the

**TABLE 3A:**

#### STRATEGIES IMPLEMENTED AND CONSIDERED BY CITIES IN DEALING WITH REVENUE SHORTFALLS

	Implemented in 2003	Considering for 2004
Revenue increases	312 cities	327 cities
Spending decreases	201 cities	180 cities
Efficiency measures	120 cities	129 cities
Workforce reductions	95 cities	73 cities
Service cuts	72 cities	63 cities
Drawing down reserves 2001-2003	213 cities	Not available

*The survey did not ask city officials to indicate the relative dollar impact of each strategy employed*

works. (For a more complete discussion of the city fiscal conditions survey, see *State of the Cities Report 2004*, available in the Policy Research Division section of the LMC web site at: [www.lmnc.org](http://www.lmnc.org).)

These decisions are difficult and have consequences for citizens. In many cities, infrastructure maintenance is being delayed, which increases long-term costs. Library hours are being cut. In growing communities, existing service levels are stretched to cover additional development. In some communities, public safety expenditures have been reduced.

### STATE AND LOCAL GOVERNMENTS ARE STRAINED

Of course, cities are not alone in their ongoing budget struggles. Back in the heady days of billion-dollar budget surpluses, the state cut income taxes and license tab fees and took over responsibility for funding basic education costs. The Dot-Com bust and recent recession, however, yielded successive years of state budget deficits across the country. At the state and local levels, budgets have been cut and cut again. The state of Minnesota responded to its deficit by draining reserves, cutting spending, reducing support for local government services, using accounting shifts, and enacting modest fee and fine increases.

Dramatic cost increases in employee health care, state health care programs, and special education are squeezing out other budget priorities. As a result, critical needs are not being fully met: Our schools are cutting budgets every year; our transportation system is deteriorating as congestion grows; tuition is increasing by double digits; basic city services are being compromised.

The current state budget forecast is based on very optimistic assumptions about the growth of our economy. It also does not account for the impact of inflation on the cost of delivering services. Even if the forecast's rosy economic predictions are realized, the state may face another billion-dollar deficit in 2005. Given the previous several months of mixed economic news, the state will not likely "grow" its way out of a deficit situation.

With another budget deficit looming, how should we collectively respond? We believe that our citizens have been presented with a false choice—cut important services that are critical to our state's long-term success or make our state uncompetitive and our government unaffordable by increasing taxes. The reality is quite different, both on the revenue and expenditure sides. While Minnesota has state tax rates well above the national average, the total tax revenue that state and local governments generate from taxpayers has declined as a share of personal income from 18.3 percent in 1994 to 15.6 percent in 2004, according to the Minnesota Department of Finance Price of Government Report. Many other states raise more revenue through local government taxes and receive more federal aid. Further, according to the Minnesota Taxpayers Association, when you compare all state and local government expenditures as a percent of personal

income, Minnesota ranked 22<sup>nd</sup> in 2002—only about 6 percent above the national average<sup>1</sup>.

More importantly, we think that Minnesota's public investments have served the state well by supporting high-quality public services and bolstering a healthy economy. Minnesotans have experienced a significant increase in average per capita income, from about \$9,100 in 1959 to almost \$23,200 in 1999 (both in 1999 dollars)<sup>2</sup>. Over these 40 years, Minnesota climbed from 27<sup>th</sup> highest per capita income in the nation to 11<sup>th</sup> highest. According to the most recent Census Bureau population surveys, the median household income in Minnesota (\$54,931) is third highest in the country, almost 20 percent higher than the national median (\$43,052). Based on data from the Annie E. Casey Foundation's "Kids Count 2004 Databook," Minnesota ranked second lowest in percent of children living in poverty in 2001. In 2003, Minnesota was named the fifth-healthiest state based on several indicators, including access to health providers and general health of the population<sup>3</sup>.

No one relishes increasing taxes or other revenue sources. We believe, however, that our state's future prosperity depends upon strategically increasing our investment in public infrastructure to get us back on track to national prominence. The investments we've made together through government, in education, infrastructure, and other areas, are not the only reason for our success. But the critics who complain that our collective investments have been an impediment to that success are just plain wrong.

## RECOMMENDATIONS

We believe the state should adequately fund its commitments to the public services upon which Minnesotans depend and recommend that the state:

***Fully fund LGA.*** We believe that we cannot have a strong state without strong cities. Communities throughout the state have unique needs and unequal ability to pay for basic services. Local government aid (LGA) is the critical program that ensures all Minnesota communities can provide the services and infrastructure necessary to achieve economic prosperity. The program's funding was disproportionately cut in 2003, leaving property-poor and high-need communities struggling to provide necessary services. Some cities can provide necessary services through existing local revenue sources, while others could best be assisted through diversifying the revenue sources available to cities (see Chapter 4, Flexibility). But for many others that have little property wealth or sales tax base, LGA funding is the most effective and fairest way to ensure revenue adequacy for necessary services.

***Implement a metro-area sales tax to fund transportation and transit.*** We support a thorough exploration of all transportation-funding options, including a gas-tax increase. There is broad consensus among citizens, business leaders, and policy-makers that our transportation system has not kept pace with the demands created by our state's growth. There are critical

transportation needs throughout the state. Yet transportation-funding increases have stalled at the Capitol as a political logjam over deciding which needs should be met has persisted.

We believe an important first step is to address the many transportation and transit needs of the metropolitan area by enacting a regional sales tax dedicated to transportation and transit. This would provide a critical, reliable, additional revenue source that would be more like the national norm of paying for regional transit through a regional tax source. We are not making a recommendation as to whether general fund dollars currently directed to transit would continue or be redirected.

***Increase state revenues.*** We recommend the state increase general revenues, while being mindful of the impacts on our most vulnerable citizens, to preserve and enhance the services upon which our future depends. The state significantly cut taxes in the late 1990s and made an expensive new commitment to fund K-12 education in 2001. Opting to increase taxes and other revenues is not easy. But underfunding the education of our future workforce and the infrastructure upon which businesses and citizens depend has long-term costs as well. Further cuts in funding cities to fund education or meet other needs are unacceptable. Preserving our current quality of life requires additional state revenues.

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#### Endnotes

<sup>1</sup> "How Does Minnesota Compare?" Minnesota Taxpayers Association, October 2004.

<sup>2</sup> Per capita income figures from the U.S. Census Bureau. Inflation adjustments made by LMC, based on CPI figures from the U.S. Department of Labor, Bureau of Labor Statistics.

<sup>3</sup> Morgan Quitno Press, State and City Ranking Publications.

## Chapter Four: Flexibility

**Flexibility**—As cities have become increasingly diverse in their characteristics, a “one-size-fits-all” system that limits all cities to the property tax as the major, non-state aid revenue source is increasingly unworkable. Some cities have sufficient property tax base to sustain an adequate service level, but many do not. Cities should have greater access to other tax and revenue sources than currently permitted.

Flexibility in financing services is critical because cities face a wide range of unique circumstances involving their tax base, the mix of revenues on which they depend, where the users of their services come from, and the makeup of their population. Flexibility is also critical because cities vary in terms of which services they are responsible for financing and delivering.

We believe that a full toolkit of revenue options is important so cities can:

- Best link the users of a service with those who pay for it.
- Provide an adequate amount of basic services despite cities’ varying ability to pay.
- Work to ensure stability of city revenues during economic downturns by relying on several sources of funding.

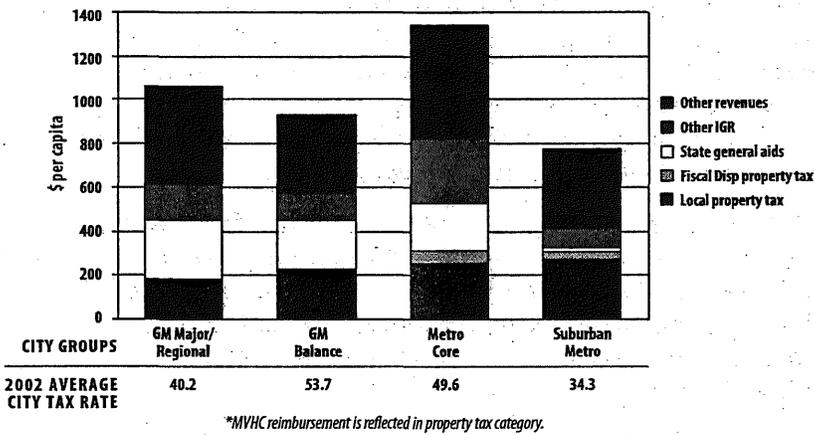
The strength and composition of the city property tax base varies from community to community. Some cities are experiencing growth and, therefore, an expansion of the property tax base. Other cities are losing population and facing a shrinking tax base, or simply growing at a much slower pace than other cities. Since tax capacity is a function of market value—how a property is currently used (residential homestead, apartment, commercial/industrial, farm, etc.) and the corresponding classification rate—the strength of the local tax base is affected by the mix of all property uses and by what portion of total property is tax exempt.

The mix of general revenue sources differs among cities (see Chart 4A on page 18). Major areas of difference include reliance on state aids, reliance on charges for services, and the fiscal disparities program that only impacts property taxes in the metro area and on the Iron Range. The chart also shows the average city tax rates for 2002 for the four city groups; here, the effects of tax base disparities become apparent. The city group that raises the most dollars per capita through the local property tax (suburban metro) also has on average the lowest city tax rates.

One of the biggest challenges in funding city services is that the costs of some services are paid by only some of those who benefit. This concept, sometimes called “overburden,” is most often identified with two distinct groups that do not fully pay for services from which they benefit: non-residents and tax-exempt property. The “revenue need” measures of the current and previous local government aid (LGA) formulae attempt to measure the impact of overburden on

The members of the four city groups shown in the chart are as follows: “greater Minnesota major/regional” = Duluth, Rochester, St. Cloud, and the 22 cities in the regional center city cluster; “greater Minnesota balance” = the remaining 690 cities outside the metro area; “metro core” = Minneapolis, St. Paul, and the 13 cities in the old cities cluster; “suburban metro” = the remaining 123 cities in the seven-county metro area. These city clusters are the same as those used for the *State of the Cities Report 2003* analysis. For a description of the clustering methodology, see *State of the Cities Report 2003*, available in the Policy Research Division section of the LMC web site at: [www.lmnc.org](http://www.lmnc.org).

**CHART 4A:**  
**MIX OF CITY REVENUES 2002\***



city services. The level of non-resident beneficiaries of services can be difficult to measure. Many users of parks, public safety services, streets, airports, and libraries are non-residents. Most of the one in five Minnesotans who live outside of incorporated cities use some city services.

Who the local taxpayers are can also be a factor in how cities decide to finance services. The state's population overall is aging, and many cities will likely see an increase in the portion of their population over age 65 over the next 20 to 30 years. It may become more difficult to increase property taxes as the number of taxpayers living on fixed incomes increases, leading cities to explore other financing options.

While the services that residents and businesses across the state receive are similar, the ways in which those services are financed varies widely. Metropolitan cities' contiguous borders and population density make regional collaboration an effective option for many services. For example:

- The responsibility for providing sewer service lies with cities in greater Minnesota and with the Metropolitan Council in most of the metro area.
- Many cities in greater Minnesota finance library services with general fund dollars, while in most of the metro area the responsibility falls to counties. For example, total per capita spending for library services in Mankato and Richfield is roughly the same (\$29.63 and \$32.07 respectively). But in Mankato, the spending is almost equally divided between city and county, while in Richfield, all of the spending is by the county.
- The Metropolitan Council provides most transit services in the metro area. In greater Minnesota, transit services are much more limited and are generally provided by the city or by multiple local governments.

## RECOMMENDATIONS

In order to enhance the flexibility of cities in funding services, we recommend the state do the following as it moves forward in its relationship with cities:

**Support revenue diversification.** The state should recognize the diversity of circumstances facing cities by granting them the authority to use the following revenue sources, creating a wider variety of tools from which cities can choose to finance city services and infrastructure:

- **The state should expand authority for a local sales tax.** The state should grant general authority to all cities to enact a local sales tax for capital projects of regional significance. Currently, only a few cities have been granted this authority. Expanded authority for the local sales tax should not adversely impact existing local sales taxes. Since many cities have little sales tax base, the authority to levy a sales tax would not diminish the importance of other revenues. This would increase revenues for capital projects, but should not reduce general operating revenue sources.
- **The state should allow cities to implement a street utility.** A street utility would help cities fund local street projects and maintenance.
- **Cities should also be able to institute other utilities.** These utilities would fund services where the benefit to and use by the public can be measured. A utility for mosquito spraying is one example.
- **The state should give cities the authority to charge impact fees.** These fees would help ensure that new development pays its fair share of the public costs of new or expanded infrastructure.
- **Cities should have the authority to capture revenues from all users of city services.** Cities need additional tools in order to link the users of city services with those who pay for those services. For example, fees assessed to non-resident users of a city's ambulance service currently serve this purpose.

**Enhance local revenue and spending autonomy.** The state should not impose artificial caps on cities' revenue. These are arbitrary and unnecessary restrictions on city revenues that do not account for the unique circumstances and needs facing cities across the state. Instead, the state should increase the autonomy given to city officials to make revenue-raising decisions. City officials are elected to determine the level of services to provide and how to finance them, whether it is through the general property tax, fees and user charges, bonding or some other mechanism. Cities should have the authority to make spending decisions that best meet the needs of their communities.

In addition, the state should not impose restrictions on local elected officials' ability to establish enterprise operations as part of creative problem-solving efforts. In many cases, enterprise operations provide innovative services not available in the private market. Cities also create enterprises as a way to better match the users of a service with those who pay for it.



## Chapter Five: Equity

*Equity—All citizens should receive adequate levels of municipal services at relatively similar levels of taxation. This means that the state should provide financial assistance to cities that have high needs or low fiscal capacity.*

Of the principles discussed in this report, equity may be the hardest to measure and the most subjective. What appears equitable to one person may seem patently unfair to another. Historically, some of the thorniest issues regarding our state-local finance system revolve around differing interpretations of equity.

The Minnesota Miracle reforms of the late 1960s and early 1970s addressed equity issues by creating a system of centralized revenue collection and decentralized service delivery. More public dollars were raised at the state level through revenue sources that took into account individual taxpayers' ability to pay. The revenues were shared with local governments through intergovernmental transfers that took into account local governments' ability to raise revenues locally. At that time, the state initiated its first sales tax to fund a complex new system of intergovernmental aids, including local government aid (LGA).

The Department of Revenue's "Model Revenue System for Minnesota" identifies two useful ways to measure equity: the benefits principle and the ability-to-pay principle<sup>1</sup>. For goods and services where a direct link can be made between the individual user and the level of benefit they receive, government may want to charge the user for the cost of the service. For goods and services with a broad public benefit, a general tax may be a more appropriate revenue source. In either case, however, the fairness of the tax or fee depends upon the ability to pay of those charged.

Minnesota's state-local tax system is less regressive than that in most states, with tax burdens that are roughly the same share of personal income for taxpayers across different income levels<sup>2</sup>. The state relies less on non-tax revenues, such as fees (user charges) and fines (which tend to be regressive), than other states, which also helps the system be less regressive<sup>3</sup>. But Minnesota's tax system has become more regressive in the past five years, as the state has reduced its reliance on the progressive income tax and increased its reliance on fees and fines.

Local governments' main source of tax revenue is the property tax. Of the major general taxes, the property tax is the least popular and arguably has the most problematic equity issues. Property wealth is not always a good indicator of ability to pay, such as when a senior on a fixed income lives in a home that is rapidly appreciating in value.

The share of Minnesota local property taxes paid by residential homesteads increased from 39 percent in 1997 to 51 percent in 2004. Most of this change can be attributed to changes in state tax policy. This trend is likely to continue with the continuing phase in of policy changes enacted in 2001. The recent severe aid and credit cuts to cities

**The Legislature has made several changes to the property classification rates for homesteads and commercial/industrial property. These changes have resulted in homestead property growing significantly as a portion of total tax capacity, while commercial/industrial property has declined as a portion of total tax capacity. Most of the local property tax is levied on tax capacity.**

and counties, and widespread school referendum levy requests, will continue to put pressure on property tax payers.

LGA is one of the most critical pieces in making our state-local fiscal system equitable. LGA enables low property-wealth and high-need cities to provide services at a reasonable tax rate. Over the years, state policy-makers have raised concerns about the equity of the LGA program. These concerns have been largely addressed by legislative action. In 1993, the formula was changed to sever the relationship between spending levels and LGA. The 2003 Legislature implemented a new distribution formula and eliminated most of the grandfathered aid base, distributing nearly all of the appropriation through the formula. Some modifications may still improve the equity of the program, such as eliminating taconite aid from the measure of ability-to-pay. We believe that the major, outstanding issue with the program is that it is not fully funded and therefore cannot adequately address the inequities in property-wealth among cities (see Chapter 3, Adequacy).

## RECOMMENDATIONS

The Legislature must continually monitor the system for tax burden equity, considering both the principles of benefit and ability to pay. We recommend the state do the following in order to enhance the equity of our state-local finance system:

**Mitigate excessive property tax burdens.** The state should fully fund the LGA program. Deep cuts in aids to local governments, growing school funding needs, and the phase out of the limited market value program are all increasing property tax burdens. The state should target more property tax relief to individuals through the circuit breaker and related programs when taxes increase rapidly or when burdens are excessive relative to income. In addition, the state should provide adequate tax relief to all types of property in low property-wealth and high-need communities.

**Connect the costs and benefits for services.** In accordance with the benefits principle, the burden of service costs should be fairly compensated by all users through fees and taxes. The state should provide cities with tools to enable the costs of services to align with the service beneficiaries. For example, a local sales tax may be a useful tool for a regional center to capture the burdens placed on its infrastructure by commuters, tourists, and tax-exempt property. In situations where charging the users is not feasible or appropriate, the state should adequately compensate communities for the overburden through LGA or other mechanisms.

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### Endnotes

<sup>1</sup>"Model Revenue System for Minnesota," Minnesota Department of Revenue, July 1992.

<sup>2</sup>"Who Pays? A Distributional Analysis of the Tax Systems in all 50 States (2<sup>nd</sup> edition)," The Institute on Taxation and Economic Policy, January 2003. A related issue is federal deductibility, for which state and local taxes are eligible but fees and charges paid are not.

<sup>3</sup>"The Appropriate Role of User Charges in State and Local Finance," National Conference of State Legislatures, July 1999.

# Appendix A: Statement of Purpose

## PURPOSE

The League of Minnesota Cities Board of Directors created the Financing Local Government Task Force to examine how local government services are now delivered and financed, to identify weaknesses and inequities in the system, and to recommend changes to that system as seem warranted.

## BACKGROUND

Since the inception of the Minnesota Miracle in the early 1970s, the local government finance system has been based on the belief that, except for the property tax, cities should have limited taxing authority. In return, state-collected sales and income tax revenues have been distributed to cities generally based on need and their property tax capacity relative to other cities. The goal has been to ensure that residents receive adequate services without paying inordinately different taxes, regardless of where they are located.

Throughout the years, there have been concerns about the fairness of the major vehicle for redistributing state collected funds to cities—the local government aid (LGA) program. These concerns have generally fallen into two categories: perceptions that the distribution formula is unfair, (i.e., that certain cities receive too much or little compared to others); or, that the overall funding level is inadequate or too high.

The significant differences that exist between cities in how some services their residents receive are funded further compounds those concerns. Libraries and transit, for example, might be part of one city's budget and be provided by the county or special district in another, yet residents in both communities pay for these services. Likewise, economies of scale that might accrue because of geographic proximity are hard to value, but clearly exist. Labor costs—the major expenditure in municipal operating budgets—also vary considerably.

In the last five years alone, state aid to cities has fallen by more than 28 percent when measured on a per capita basis. This reduction appears to have been partly due to the state's budget deficit, but also to a changing philosophy among some influential state government leaders about the state's role in financing local government services. Moreover, changes to the system now occur with increasing frequency creating instability and unpredictability.

Cities throughout the state are becoming more reliant on their own residential property tax base to fund services. State aid cuts, for example, have increased cities' reliance on property taxes. Further, class rate compression and phasing out the limited market value program have shifted more of the property tax burden onto homestead property, which has resulted in reduction of services in some instances and increased the tax rate disparity among many cities. Left unaddressed, the underlying premise of the Minnesota Miracle—that all citizens should receive adequate levels of municipal services at relatively similar levels of taxation—will be unachievable.

## GUIDING PRINCIPLES

Cities need a viable financial partnership with the state. The League believes the following principles should guide how that partnership evolves:

- 1. Accountability**—Cities believe that a viable partnership with the state requires cities and the state to communicate effectively with each other and with the public about their roles and responsibilities. Cities and the state must also exercise sound financial stewardship, including maximizing efficiencies in service delivery and other means of cost containment whenever possible.
- 2. Certainty**—Cities need to have more certainty and predictability in all of their available revenue sources, including the property tax and the amount of funding they receive from LGA and similar programs. The current practice of almost annual adjustments to LGA and similar programs and the imposition of levy limits do not allow for prudent financial planning and decisions.
- 3. Adequacy**—The revenue sources available to cities and the state must raise adequate funds to meet city needs, to fund mandates, and to maintain Minnesota's long-term competitiveness.
- 4. Flexibility**—As cities have become increasingly diverse in their characteristics, a "one-size-fits-all" system that limits all cities to the property tax as the major, non-state aid revenue source is increasingly unworkable. Some cities have sufficient property tax base to sustain an adequate service level, but many do not. Cities should have greater access to other tax and revenue sources than currently permitted.
- 5. Equity**—All citizens should receive adequate levels of municipal services at relatively similar levels of taxation. This means the state should provide financial assistance to cities that have high needs or low fiscal capacity.