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To: City Officials
State Legislators

From: Patricia Awada, State Auditor

Date: May 27, 2003

Enclosed is a copy of the ***2001 Revenue, Expenditures & Debt of Minnesota Cities Under 2500 in Population*** report.

This report is designed to give the citizens of Minnesota a better understanding of city finances as well as give city officials a way to compare their finances to those of other cities. We hope you find this information useful.

We have also included a brief analysis comparing cities under 2500 with those over 2500.

If you have questions please do not hesitate to contact either myself at pawada@osa.state.mn.us or (651) 296-2551, or Deputy State Auditor Tony Sutton at tsutton@osa.state.mn.us or (651) 282-6112.

Cc: Governor Tim Pawlenty
Commissioner of Finance Dan McElroy
Commissioner of Revenue Dan Salomone
League of Minnesota Cities

Comparison of 2001 Finances for Cities Under and Over 2,500 in Population

Revenues

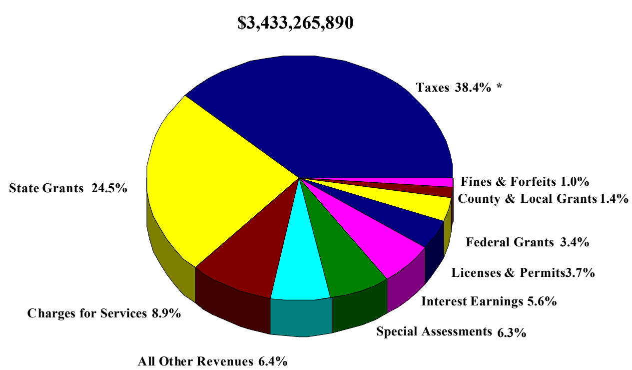
There are significant differences in how city services are funded between cities over and under 2,500 in population. One difference is that cities under 2,500 are much more dependent on intergovernmental revenues than cities over 2,500. In 2001, intergovernmental revenues accounted for 40 percent of total revenues for cities under 2,500 in population (small cities) compared to 29 percent for cities over 2,500 in population (large cities). Interestingly, property taxes account for about the same share of total revenues for these two groups of cities. For large cities, property taxes accounted for 24 percent of total revenues compared to 23 percent for small cities.

Large cities make up for the difference in intergovernmental revenues by taking advantage of other tax revenue streams such as tax increments from tax increment financing (TIF) districts, franchise, lodging, and local sales taxes. As a whole, tax revenue from all sources accounted for 38 percent of large city revenues in 2001, compared to 27 percent of small city revenues. Large cities also utilize tax increment financing to a much greater extent than small cities. Revenue derived from TIF districts accounted for 3 percent of small city total revenues compared to 9 percent for large cities.

On a per capita basis, large cities had total revenues of about $108 more than small cities ($954 to $846).

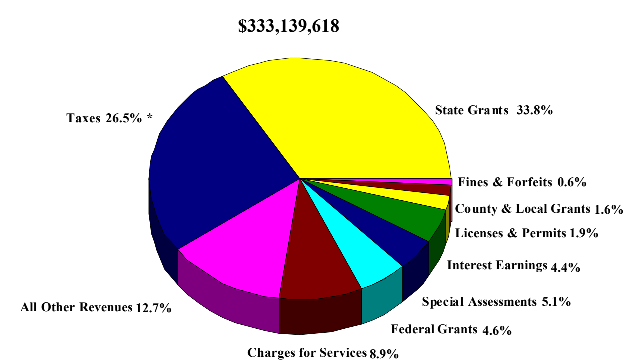
The following pie charts illustrate the differences in revenue sources for cities over and under 2,500 in population.

Total Governmental Revenues - Cities Over 2,500 in Population



* This category includes property, hotel/motel, sales, franchise, gravel, and gambling taxes as well as tax increments.

Total Governmental Revenues - Cities Under 2,500 in Population



* This category includes property, hotel/motel, sales, franchise, gravel, and gambling taxes as well as tax increments.

Enterprise Funds

In addition to governmental funds, many cities establish enterprise funds to account for services that are financed and operated in a manner similar to private business enterprises. These enterprises are intended to be self-sustaining through fees and user charges. Although some enterprises earn a net income, most have the objective of breaking even. The most common enterprises created by cities are electric, gas, sewer, water, and heat utilities.

Cities under 2,500 in population are more reliant on these enterprises to help support their governmental fund activities. In 2001, net transfers from enterprise funds to governmental funds (excluding liquor store profits) totaled $9.5 million and represented 3 percent of all revenue sources. Cities over 2,500 had net transfers of $70.4 million from enterprise funds to governmental funds. This represented 1 percent of their revenue sources.

In addition, small cities made net transfers of $3.6 million and large cities made net transfers of $10.7 million from liquor store enterprise funds to governmental funds. This represented 1.1 percent of the total revenues for small cities and 0.3 percent of the total revenues for large cities.

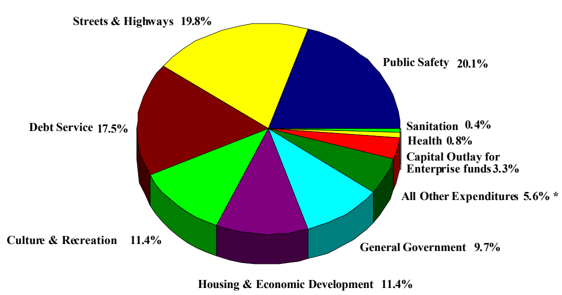
Expenditures

The spending priorities of cities under 2,500 in population differs from those cities over 2,500 in population. For example, cities under 2,500 tend to direct a greater percentage of their resources to general government (15.2% to 9.7%) and less to culture and recreation (7.8% to 11.5%) than cities over 2,500. In addition, streets and highways are the largest category of spending for cities under 2,500 in population compared to public safety for those cities over 2,500.

The following pie charts show the differences in spending priorities for cities over and under 2,500 in population.

Total Governmental Expenditures - Cities Over 2,500 in Population

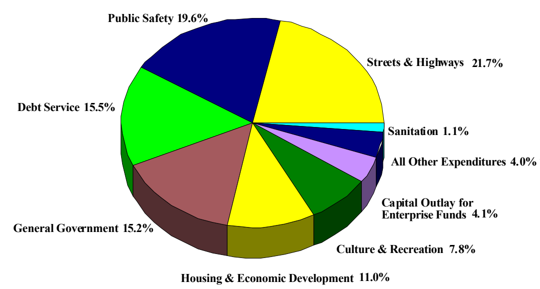
$4,080,953,060



* Includes conservation of natural resources, airport, transit, unallocated insurance, and all other unallocated expenditures.

Total Governmental Expenditures - Cities Under 2,500 in Population**

$386,365,847



* Includes airport, health, unallocated insurance, and all other unallocated expenditures.
** Includes current expenditures, capital outlays, and debt service, but excludes transfers to Enterprise Funds.

Long-Term Debt

Another area where small and large cities differ is in their use of debt. Overall, small cities tend to carry a greater debt burden than large cities. In 2001, small cities carried long-term debt of $720.9 million or $1,830 per capita compared to $6.28 billion or $1,747 per capita for large cities.

2000 Census Changes City Classifications

The release of the 2001 Revenues, Expenditures, and Debt series for cities over and under 2,500 in population requires additional analysis because of changes prompted by the 2000 census. Cities are classified as over or under 2,500 in population by the census which is taken every ten years. The population that a city has when the census is taken determines whether it is classified as over or under 2,500 in population for the next ten years. Even when a city gains or loses population during the next ten years, it remains classified based on its population at the time of the last census. The 2001 Revenues, Expenditures, and Debt publications are the first to group cities based on the 2000 census.

The 2000 census populations changed the classification of 26 cities. Twenty-four cities moved from under to over 2,500 in population, and two moved from over to under 2,500 in population. The following analysis compares 2000 and 2001 financial data for cities based on their 2001 classifications. To do the analysis, the 2000 data for cities over 2,500 was revised by adding the 24 cities that gained population into the data set, and removing the two cities that lost population. The 2000 data set for cities under 2,500 was revised by removing the 24 cities that gained population, and adding the two cities that lost population.

The revisions to the data sets had the following affect on year-to-year changes for cities over 2,500:

Cities Over 2,500 in Population

Category	2001	2000 Unrevised	Percent Change	2000 Revised	Percent Change
Total Current Expenditures	$2,020,872,134	$1,888,718,549	7.0%	$1,918,304,879	5.3%
Total Capital Outlays	1,347,940,294	1,193100,841	13.0%	1,217,363,843	10.7%
Debt Service	712,140,632	586,003,415	21.5%	605,801,305	17.6%
Total Expenditures	4,080,953,060	3,667,822,805	11.3%	3,741,470,027	9.1%
Property Taxes	837,890,401	758,115,408	10.5%	776,277,074	7.9%
Total Intergovern-mental Aid	1,016,903,929	973,491,763	4.5%	986,017,382	3.1%
Service Charges	305,485,816	265,718,295	15.0%	273,876,198	11.5%
Total Revenues	3,433,265,890	3,314,102,294	3.6%	3,376,935,203	1.7%
Net Transfers (Enterprise Funds)	70,369,558	57,096,721	23.2%	58,339,290	20.6%
Net Income (Enterprise Funds)	262,085,043	257,200,606	1.9%	263,498,872	-0.5%

The following table shows the effect of the population changes on cities under 2,500:

Cities Under 2,500 in Population

Category	2001	2000 Unrevised	Percent Change	2000 Revised	Percent Change
Total Current Expenditures	$207,998,561	$224,923,835	-7.5%	$195,337,505	6.5%
Total Capital Outlays	118,408,431	149,095,216	-20.6%	124,832,214	-5.1%
Debt Service	59,958,855	76,005,433	-21.1%	56,207,543	6.7%
Total Expenditures	386,365,847	450,024,484	-14.1%	376,377,262	2.7%
Property Taxes	76,642,207	93,731,892	-18.2%	75,570,226	1.4%
Total Intergovern-mental Aid	133,063,780	144,426,178	-7.9%	131,900,559	0.9%
Service Charges	29,669,939	34,604,981	-14.3%	26,447,078	12.2%
Total Revenues	333,139,618	381,581,485	-12.7%	318,748,567	4.5%
Net Transfers (Enterprise Funds)	9,481,373	13,020,944	-27.2	11,778,375	-19.5%
Net Income (Enterprise Funds)	23,867,621	31,865,538	-25.1%	25,567,272	-6.6%

Impact of Census Count on Year-To-Year Changes in City Finances

The movement of 24 cities from the under 2,500 to over 2,500 in population classification had a much greater impact on the overall year-to-year financial trends for cities under 2,500. The cities that moved to the over 2,500 in population group were some of the largest and fastest growing among cities under 2,500 in population. The two categories that were impacted the most were capital outlays and service charges. This is not surprising because fast growing communities tend to have the greatest need for infrastructure improvements that are often financed by fees charged to developers and property owners.

In contrast, the addition of the 24 cities had little impact on the finances of cities over 2,500 in population. While these 24 cities were the largest and fastest growing among cities under 2,500, they are relatively small compared to many of those cities over 2,500.

One area of concern for small cities is in the area of enterprise operations. Between 2000 and 2001, the net income of enterprise operations (excluding municipal liquor stores) was down 7 percent after the adjustment for the census changes. Net transfers (transfers out minus transfers in) were down 20 percent. In addition, net transfers from liquor stores were down an adjusted 1.5 percent. This could have an impact on small city finances because transfers represent about 3 percent of the total revenues of small cities.

Accounting Difference for Cities Over and Under 2,500 in Population

For cities in Minnesota, the classification as over or under 2,500 in population helps to determine the type of governmental accounting to which they must adhere. All cities over 2,500 in population must have an annual audit that follows Generally Accepted Accounting Principals (GAAP) which is a modified accrual basis of accounting. Modified Accrual Basis accounting recognizes an economic transaction or event as revenues in the operating statement when the revenues are both measurable and available to liquidate liabilities of the current period. Available means collectible in the current period or soon enough thereafter to be used to pay liabilities of the current period. Similarly, expenditures are generally recognized when an event or transaction is expected to draw on current spendable resources.

Cities under 2,500 may opt to use a cash basis of accounting. In 2001, 357 of the 646 small cities (55 percent) opted to use a cash basis of accounting. Cash basis accounting provides for the recording of revenues when received in cash and the recording of expenditures when paid in cash. While cash basis accounting may be allowed under Minnesota Statutes, it does not facilitate accurate reporting of financial position.

This difference in accounting methods is most pronounced when reporting fund balances. Cities that use a modified accrual basis of accounting report their fund balances as reserved, unreserved designated, and unreserved undesignated for each fund they have. Cities that use a cash basis of accounting report a single cash balance for all funds. Therefore, a comparison of fund balances between the two groups of cities is inappropriate.