MINNESOTA · REVENUE

February 18, 2003

The Minnesota Legislature
State Capitol
St. Paul, Minnesota

Dear Legislators,

I am pleased to present the Governor's budget proposal as it relates to reducing and reforming local government aid expenditures and changing state tax laws. These changes reflect the Governor's commitment to balancing the state budget, restoring reserves, reducing the rate of growth in state expenditures, and protecting basic services and high-priority programs without increasing taxes.

Changes in Local Government Aids

Aid to Cities

The Governor recommends that aid to cities in fiscal years 2004-05 be $1.07 billion. This represents a $435 million or 29 percent reduction from previous forecast. These reductions focus on Local Government Aid (LGA), and in some cases Market Value Credits. Recognizing that calendar 2003 local budgets are already set, the aid reductions are "back-loaded" with 32 percent of the total reduction in calendar 2003, and 68 percent in calendar 2004. The Governor also recommends strict levy limits for calendar 2004 to ensure that the aid reductions result in local spending adjustments instead of property tax increases. However, city property taxes can exceed the limit with voter approval.

To accommodate the recommended reductions without tax increases, cities will need to reduce total spending by an average of 3.8 percent in 2003, and 7.4 percent in 2004. Budgetary impacts are relatively uniform, and are capped at 5 percent and 9.5 percent of estimated total revenues for 2003 and 2004 respectively.

The Governor recommends that LGA for calendar 2005 be distributed through a new need/capacity formula that applies certain criteria that will be released by the Administration shortly. The new formula will be developed in consultation with city officials. The funding level for LGA in 2005 will be contingent on enactment of an acceptable formula.

Aid to Counties

The Governor recommends that county aid be $722.8 million in the 2004-05 biennium. This represents a reduction of $189.4 million or 20 percent from previous forecast. These changes will consist of reductions in such programs as HACA, Family Preservation Aid, County Criminal Justice Aid, Attached Machinery Aid, and Out-of-Home Placement Aid and, if needed, the Market Value Credit. Similar to cities, county aid reductions are back-loaded to FY2004. In calendar year 2004, most existing county aid programs are ended and a single new aid program with a formula based on both need and capacity is created

On a budgetary basis, these changes will require county budget reductions averaging 1.6 percent in 2003, and 2.8 percent in 2004, with budget reductions capped at 2 percent of total revenues in 2003, and 3 percent in 2004. The funding level for county aids in calendar years 2005 and 2006 will be contingent on reform.

There are also some aid changes that effect townships, special districts, and schools. Under the aids category, the Governor is also recommending repeal of the small Used Oil Filter Refund program.

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Tax Changes

Tax-Free Zones

The Governor’s major tax initiative this session will be a proposal for tax free zones called Job Opportunity Building Zones or JOBZ. The details of this proposal will be released separately, however, we are including a placeholder budget initiative at this time.

In order to spark economic development in economically struggling areas of Minnesota, the Governor is proposing the creation of up to 10 tax-free zones. Individual and business activities within these zones will enjoy broad exemptions from individual and corporate income taxes, sales taxes on building materials, equipment and vehicles used in the zone and property taxes on improvement to land in the zone. This proposal is based on successful plans enacted in recent years in Pennsylvania and Michigan.

Eligible areas include cities, counties and towns outside the seven-county Metro area that are suffering economic distress. To gain tax-free zone designation, interested eligible local governments will develop an economic development plan. The plans will be submitted to the Commissioner of Trade and Economic Development during a fixed application period. The Commissioner will evaluate all submitted plans and grant tax-free zone status to up to 10 areas, based on need and likelihood of success, as measured by criteria such as the quality of the development plan and local public and private support for the plan.

At present, the proposal is estimated to save businesses and individuals a total of $5.5 million during fiscal years 2004-2005.

Other tax initiatives being recommended by the Governor include:

- Permanent extension of the current accelerated June sales tax payment;
- Changes in the disposition of lottery in lieu of sales tax payments;
- Changes in the dedication of the cigarette tax, moving the dedication away from the future resources fund and toward medical education research at both the University of Minnesota and the Department of Health;

The Governor is also recommending that funds now in the medical education endowments be transferred to the general fund to restore budgetary reserve quickly.

I look forward to working with you as we begin to debate and address these very important actions.

Sincerely,

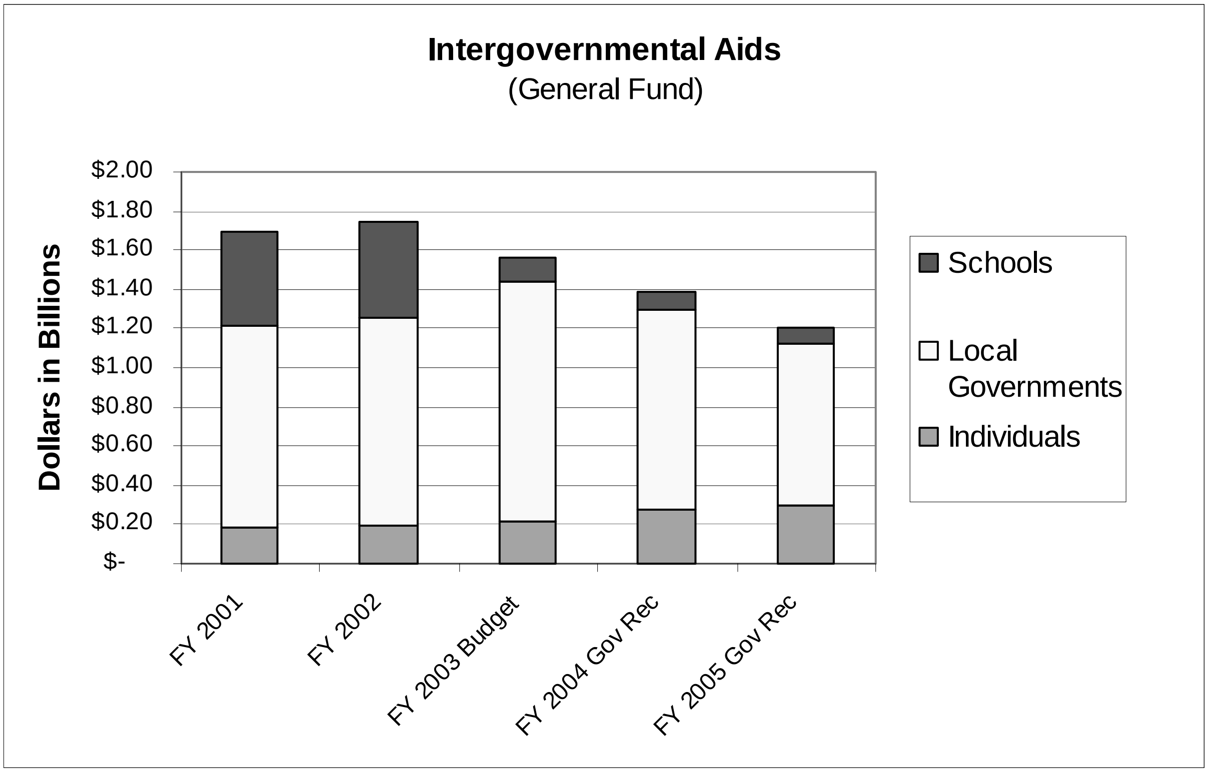
Daniel A Salomone

Dan Salomone

Summary of Intergovernmental Aid (General Fund)

dollars in $000s

	FY 2001	FY 2002	FY 2003 Budget	FY 2004 Gov Rec	FY 2005 Gov Rec
TOTAL	**1,722,379**	**1,779,747**	**1,609,498**	**1,418,920**	**1,238,776**
Individuals	**184,790**	**195,154**	**219,251**	**272,708**	**291,436**
RENTERS CREDIT	115,389	118,961	129,505	137,449	145,622
PROPERTY TAX REFUND	68,189	72,851	88,685	117,042	129,625
PROPERTY TAX REFUND - TARGETED	1,163	3,293	1,011	14,400	11,800
USED OIL & FILTER REFUND	49	49	50	-	-
FOREST LAND CREDIT PROGRAM	-	-	-	3,817	4,389
School	**471,809**	**490,746**	**118,971**	**86,674**	**89,088**
RESIDTL HMSTD MV CREDIT	-	-	57,652	70,888	72,906
EDUCATION HOMESTEAD CREDIT	387,811	404,992	41,257	305	34
DISPARITY REDUCTION AID	10,365	10,393	7,529	8,494	8,708
EDUCATION AGRICULTURAL CREDIT	41,381	54,199	5,512	-	-
AGRIC HMSTD MV CREDIT	-	-	3,198	5,499	5,836
HMSTD AGR CR AID-HACA	29,655	18,333	1,720	-	-
ATTACHED MACHINERY AID	836	836	836	-	-
BORDER CITY CREDIT	1,199	1,423	703	932	1,066
TACONITE AID REIMBURSEMENT	561	561	561	533	533
DISASTER CREDIT / REV	-	8	3	23	5
ENTERPRISE ZONE CREDIT	1	1	-	-	-
County, City, Town and Special District	**1,034,544**	**1,055,911**	**1,222,100**	**1,027,535**	**826,527**
LOCAL GOVERNMENT AID (LGA)	394,526	411,926	564,991	466,063	352,012
RESIDENTIAL MV CREDIT	-	-	257,935	225,730	196,956
HOMESTEAD AGR CREDIT AID-HACA	471,634	470,327	207,467	134,467	18,702
AID TO POLICE & FIRE (Pension)	59,391	56,228	59,694	67,753	73,518
CRIMINAL JUSTICE AID	29,411	30,575	31,600	32,476	-
FAMILY PRESERVATION AID	21,721	22,644	23,406	23,991	-
PERA AID (Pension)	14,774	14,586	14,586	14,586	14,586
AGRICULTURAL MV CREDIT	-	-	14,355	18,396	18,396
DNR-PILT (appr -DNR, exp DOR)	*-*	*11,779*	*12,046*	*12,457*	*12,693*
DISPARITY REDUCTION AID	13,022	13,015	9,920	10,922	11,019
POLICE & FIRE AMORTIZATION (Pension)	9,461	11,062	9,288	9,252	7,883
SUPPLEMENTAL TACONITE AID	559	570	3,911	4,752	4,842
WASHBURN-CROSBY PROJECT	-	-	2,600	-	-
ATTACHED MACHINERY AID	2,382	2,382	2,382	-	-
BORDER CITY CREDIT	3,419	3,970	2,339	3,401	3,739
EXISTING LOW INC HOUSING AID	614	1,697	1,769	2,029	233
TIF DEFICIT AID	1,020	1,988	1,631	-	-
FLOOD RELIEF-PROPERTY TAX AID	-	-	1,000	-	-
INDIAN CASINO COUNTY AID	734	693	693	693	693
PUBLIC DEFENDER COSTS	-	285	480	492	505
DISASTER CREDIT/REV	-	26	7	75	-
COUNTY NEED CAPACITY AID	-	-	-	-	110,750
CHARITY CARE AID	10,000	-	-	-	-
REGIONAL TRANSIT BRD AID	1,864	2,154	-	-	-
FARM AID	9	1	-	-	-
ENTERPRISE ZONE CREDIT	3	3	-	-	-
Non Aid Items in Fund Balance	**31,236**	**37,936**	**49,176**	**32,003**	**31,725**
Political Contribution Refund	5,198	4,485	5,000	5,000	4,800
Ore Prod Tax replacement Aid	-	12,967	7,676	6,868	6,868
Tax Refund Interest	26,038	20,484	36,500	20,000	20,000
Tax Free Zones (JOBZ)				135	57


Intergovernmental Aids
(General Fund)
Dollars in Billions
$2.00
$1.80
$1.60
$1.40
$1.20
$1.00
$0.80
$0.60
$0.40
$0.20
$-
FY 2001
FY 2002
FY 2003 Budget
FY 2004 Gov Rec
FY 2005 Gov Rec
Schools
Local Governments
Individuals

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	($140,729)	($294,000)	($270,000)	($290,000)
Revenues	0	0	0	0
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact	($140,729)	($294,000)	($270,000)	($290,000)

Recommendation

The Governor believes that cities, like all agencies, programs, organizations, and individuals that depend on state financial resources from the State, must share the burden of solving the current budget problem. All must be prepared to exist with reduced state resources.

The Governor recommends that in the 2004-05 biennium local aid payments to cities be $1.07 billion. This represents a reduction of $435 million or 29%. For most cities, this reduction is limited to the Local Government Aids (LGA) program and in some cases Market Value Credit payments. Recognizing that calendar 2003 local budgets are already set, the Governor is recommending that the reductions in the first year of the biennium be limited to roughly one-third of the total. This will give cities additional time to plan for the larger reductions in the second year of the biennium. The Governor is also recommending strict levy limits (with referendum override) for calendar year 2004 and beyond. This will ensure that to the maximum extent possible, the state aid reductions will result in local spending adjustments instead of property tax increases.

Background

Minnesota has a long history of supplementing local government revenues with state general fund aid payments. Advocates of state aid payments have advanced several reason for this financial relationship including:

- state aid payments help communities with limited property wealth to provide basic local services without undue property tax burden;
- state aid payments help offset the cost of state mandates; and
- state aid payment helps limit overall property tax burden.

Critics of the current aid system have also advanced several criticism including:

- state aid distribution formulas are often not based on need but on historical spending patterns;
- state aid programs do not have specific objectives or accountability measures; and
- state aid drive increased spending by local governments not reduced property taxes.

It is important to note, for this budget recommendation, local aids is a subset of many different state payments to cities. The state paid aids considered in this budget initiative are those included in the forecast and general fund balance under the heading of Intergovernmental Aids. These are paid to cities by the Department of Revenue. It does not include things like local transportation aid (paid by MnDOT) or other payments by other state agencies.

FY 2004 / Calendar 2003

Because local budgets, including property tax levies and anticipated aids, are already set, cities will be forced to make up aid reductions with spending reductions. Because this will put cities in a reactive mode, the Administration decided that the aid reductions should be “back loaded” (FY 04 reduction would be substantially less then FY 05 reduction).

The Administration also rejected a straight percentage of aid as the basis of the reduction because it would not share the burden of the reduction as widely as possible. Under the straight percentage scenario, cities with budget highly dependent on aids would take very large cuts, while cities with small or no reliance on aids would face minimal or no reductions. Local *"aids"* represent only the state-paid portion of the overall property tax revenue system while *"levy plus aids"* represents the total revenues of the overall property tax system. The Administration decided that the fairest basis on which to allocate reductions to cities was levy plus aids rather then aids only.

In allocating the calendar 2003 city aid reductions, the Administration started by calculating **9.3% of calendar year 2003 levy plus aid**. This was generally smaller then the reductions proposed for state agencies and other state services. This initial reduction was then compared to that cities' total revenues as stated in the most recent State Auditor reports (generally 2000 or 2001). In this context, *Total revenues* exclude local unit grants and borrowing but includes "net" transfers from enterprise funds. Three separate "caps" were imposed in determining the final aid reduction. These were:

- **5.0% of total revenue** for cities with populations over 1,000
- **3.5% of total revenues** for cities under 1,000
- **3.5% of total revenues** for cities with a three-year average levy plus aid growth rate less than 2%.

Once the final aid reduction is determined for each city, the reduction is applied first to anticipated LGA payments and then to anticipated Market Value Credit payments if necessary.

FY 2005 / Calendar 2004

Because local budgets are not set for this year, cities have more opportunity to plan for aid reductions and the associated spending adjustment required. Therefore, the Administration has recommended a larger reduction in this year.

In CY 04, the Administration started by developing individual city reduction target based on percent of total revenue as presented in the latest State Auditor report (rather then levy plus aid). The Administration decided this basis would be most comparable to other agencies, institutions, and programs facing General Fund reductions. The individual targets were established using the following parameters:

- **9.5% of total revenues** for cities with population greater than 1,000
- **8.0% of total revenue** for cities with populations less than 1,000
- **8.0% of total revenues** for cities with a three year levy plus aid growth rate of less then 2.0%

To set a policy direction on LGA, the Administration then calculated a minimum CY 04 LGA payment by distributing $250 million under the current LGA formula (excluding grand-fathered and including specific caps for first class cities).

The difference between the current CY 03 LGA for each city and the CY 04 minimum payment, calculated above, create a maximum LGA reduction amount for each city. If the maximum LGA reduction amount exceeds the initial targeted reduction (percent of OSA revenue stated above), then the city's CY04 LGA reduction equals the targeted amount. If the maximum LGA reduction is less than the initial targeted reduction, then the city's CY 04 LGA reduction equals the maximum LGA reduction, and the city's Market Value Credit payment will also be reduced until the combined LGA plus Market Value Credit reduction equals the targeted reduction amount or the Market Value Credit payment is zero.

The Administration believes that these reductions can and should be absorbed by the cities through spending restraint rather than raising property taxes. To ensure this, the Administration is recommending strict levy limits for CY 04. The Administration recognizes that this may be impossible for some cities, so it is recommending that these levy limits could be superceded by referendum, as allowed under current law.

Relationship to Base Budget

Aid Name	2004 Base Budget	2004 Governor's Rec	Change		2005 Base Budget	2005 Governor's Rec	Change
Cities							
AID TO LOCAL GOVERNMENT	586,849	466,063	(120,786)		607,012	352,012	(255,000)
RESIDENTIAL MV CREDIT	86,875	66,932	(19,943)		85,109	46,109	(39,000)
AID TO POLICE & FIRE	54,234	54,234	-		58,580	58,580	-
LOCAL POLICE & FIRE AMORT AID	6,244	6,244	-	-	4,875	4,875	-
PERA AID	5,413	5,413	-		5,413	5,413	-
EXISTING LOW INC HOUSING AID	1,843	1,843	-		-	-	-
BORDER CITY CREDIT	1,427	1,427	-		1,571	1,571	-
AGRIC MV CREDIT	240	240	-		240	240	-
DISASTER CREDIT/REV	26	26	-		-	-	-
	743,151	**602,422**	**(140,729)**		**762,800**	**468,800**	**(294,000)**
			-18.9%				-38.5%

The table above shows how all of the city aids categorized as Intergovernmental aids are affected in both years of the biennium by the Governor's recommendation. The table below puts the Governor's recommendation into the overall context of the city's total revenues and total budget.

Governor's Proposed CY 2003
City Aid Reduction
As a Percent of
Total City Revenues (OSA)

	Cities	
Percent Change	**Number**	**Percent**
Less than 1.0%	18	2.1%
1.0% --- 3.5%	119	14.0%
3.5% --- 5.0%	554	64.9%
At 5.0% cap	162	19.0%
Total	853	100.0%

Average -- 3.8% of total revenues

Governor's Proposed CY 2004
City Aid Reduction
As a Percent of
Total City Revenues (OSA)

	Cities	
Percent Change	**Number**	**Percent**
Less than 3.0%	65	7.6%
3.0% --- 5.0%	54	6.3%
5.0% --- 8.0%	524	61.4%
8.0% --- 9.5%	20	2.3%
At 9.0% cap	190	22.3%
Total	853	100.0%

Average -- 7.4% of total revenues

Change Item: ELIMINATE ATTACHED MACHINERY AID - SCHOOLS

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	($ 836)	($ 836)	($ 836)	($ 836)
Revenues	0	0	0	0
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact	($ 836)	($ 836)	($ 836)	($ 836)

Recommendation

As part of overall Local Aid Reform, the Governor recommends the elimination of the Attached Machinery Aid program. This program provides aid payments to a very few local governments. In the Governor's opinion, this program has outlived the purpose for which it was created.

The repeal of this program will affect aid payments to twelve individual school districts. The potential negative levy impacts of this change will be offset by positive changes in the K-12 bill in all but one district.

Background

The Attached Machinery Aid program was created in the early 1970s. It was designed to reimburse certain local governments for local revenue lost when attached business machinery was exempted from property tax. The actual machinery originally compensated for, in all likelihood, no longer exists. It has likely been replaced with new equipment, yet the old aid payments continue.

A limited number of counties and school districts now receive this aid. This change item addresses only the public school impact of this change.

Relationship to Base Budget

The table below illustrates the repeal of attached machinery aid in the context of the other general fund property tax aids received by school districts for both years of the biennium. This does not include basic state paid general education aids paid by Department of Education.

Aid Name	2004 Base Budget	2004 Governor's Rec	Change	2005 Base Budget	2005 Governor's Rec	Change
School -TOTAL						
RESIDTL MV CREDIT	70,888	70,888	-	72,906	72,906	-
DISPARITY REDUCTION AID	8,494	8,494	-	8,708	8,708	-
AGRIC MV CREDIT	5,499	5,499	-	5,836	5,836	-
BORDER CITY CREDIT	932	932	-	1,066	1,066	-
TACONITE AID REIMB	533	533	-	533	533	-
EDUCATION HOMESTEAD CREDIT	305	305	-	34	34	-
DISASTER CREDIT/REV	23	23	-	5	5	-
ATTACHED MACHINERY AID	836	-	(836)	836	-	(836)
	87,510	**86,674**	**(836)**	**89,924**	**89,088**	**(836)**
			-1.0%			-0.9%

To get an idea of how these changes affect the individual school districts, two comparisons are useful. The first is the attached machinery aid as a percent of Adjusted Net Tax Capacity (ANTC). For the twelve affected school districts, the average change is 0.9% of ANTC, and it ranges from 0.3% of ANTC to 2.6% of ANTC. Six districts are below 1% of ANTC, four are between 1% and 2% of ANTC, and two are over 2% of ANTC.

The second comparison is the attached machinery aid on a per-pupil basis. On a per pupil basis, the average change due to repeal of attached machinery aid is $30.64, and it ranges from $10.33 to $86.96. Using a $7,633 estimate for the current year per pupil revenues per student, the average is 0.4% of revenues, and the range is 0.1% to 1.1%.

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	($65,011)	($124,382)	($34,200)	($38,500)
Revenues	0	0	0	0
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact	($65,011)	($124,382)	($34,200)	($38,500)

Recommendation

The Governor believes that counties, like all agencies, programs, organizations, and individuals that depend on state financial resources from the State, must share the burden of solving the current budget problem. All must be prepared to exist with reduced state resources.

The Governor recommends that in the 2004-05 biennium local aid payments to counties be $722.8 million. This represents a reduction of $189.4 million or 20% from the current forecasted amount. Because of the counties unique role in delivering many state programs and services and because of pressures the counties will face in other areas of the budget, the Governor has recommended that local aid reductions for counties be less than those for cities.

Recognizing that calendar 2003 local budgets are already set, the Governor is recommending that the reductions in the first year of the biennium be limited to roughly one-third of the total. This will give counties additional time to plan for the larger reductions in the second year of the biennium. The Governor is also recommending strict levy limits (with referendum override) for calendar year 2004 and beyond. This will ensure that to the maximum extent possible, the state aid reductions will result in local spending adjustments instead of property tax increases.

The Governor recommends two reform pieces along with the overall reduction. One is the repeal of attached Machinery Aid. The second is the consolidation of a number separate formula driven aid programs into a single program with a formula based on both need and capacity. The aid programs that the Governor is recommending for consolidation include Homestead and Agricultural Credit Aid (HACA), mobile home HACA, Out of Home Placement Aid, Criminal Justice Aid, and Family preservation Aid. In consolidating HACA, all component needed to protect the county court takeover, now in law, will be preserved (either as HACA or a new program).

Background

Minnesota has a long history of supplementing local government revenues with state general fund aid payments. Advocates of state aid payments have advanced several reasons for this financial relationship including:

⇒ State aid payments help communities with limited property wealth to provide basic local services without undue property tax burden.
⇒ State aid payments help offset the cost of state mandates.
⇒ State aid payment helps limit overall property tax burden.

Critics of the current aid system have also advanced several criticism including:

⇒ State aid distribution formulas are often not based on need but on historical spending patterns.
⇒ State aid programs do not have specific objectives or accountability measures.
⇒ State aid drives increased spending by local governments not reduced property taxes.

It is important to note, for this budget recommendation, local aids is a subset of many different state payments made to counties. The state paid aids considered in this budget initiative are those included in the forecast and general fund balance under the heading of Intergovernmental Aids. These are paid to cities by the Department of Revenue. It does not include other county payments such as local highway payments, human services support payments, public health and corrections programs and grants paid by other agencies.

The Attached Machinery Aid program was created in the early 1970s. It was designed to reimburse certain local governments for local revenue lost when attached business machinery was exempted from property tax. The actual machinery originally compensated for, in all likelihood, no longer exists. It has likely been replaced with new equipment, yet the old aid payments continue. A limited number of counties and school districts now receive this aid. The Governor is recommending repeal of this aid program.

FY 2004 / Calendar 2003

Because local budgets, including property tax levies and anticipated aids, are already set, counties will be forced to make up aid reductions with spending reductions. Because this will put cities in a reactive mode, the Administration decided that the aid reductions should be "back loaded" (FY 04 reduction would be substantially less then FY 05 reduction).

The Administration also rejected a straight percentage of aid as the basis of the reduction because it would not share the burden of the reduction as widely as possible. Under the straight percentage scenario, counties with budget highly dependent on aids would take very large cuts, while counties with smaller on aids would face minimal reductions. Local *"aids"* represent only the state-paid portion of the overall property tax revenue system while *"levy plus aids"* represents the total revenues of the overall property tax system. The Administration decided that the fairest basis on which to allocate reductions to counties was levy plus aid rather then aids only.

In allocating the calendar 2003 city aid reductions, the Administration started by calculating **3.2% of calendar year 2003 levy plus aid**. This was substantially smaller then the reductions proposed for state agencies and other state services. This initial reduction was then compared to that county's total revenues as stated in the most recent State Auditor reports (generally 2000). In this context, *total revenues* exclude local unit grants and borrowing but includes "net" transfers from enterprise funds. Two separate "caps" were imposed in determining the final aid reduction. These were:

- 2.0% of total revenue for all counties; and
- 1.5% of total revenues for counties with a three-year average levy plus aid growth rate less than 2%.

Once the final aid reduction is determined for each county, the reduction is applied first to Attached machinery Aid, HACA, Family Preservation Aid, County Criminal Justice Aid, and then to anticipated Market Value Credit payments if necessary.

FY 2005 / Calendar 2004

Because local budgets are not set for this year, counties have more opportunity to plan for aid reductions and the associated spending adjustment required. Therefore, the Administration has recommended a larger reduction in this year.

For counties in CY 04, the Administration also used a levy plus aid base approach. The Administration started by calculating **6.0% of calendar year 2003 levy plus CY 04 aid**. Again, this was substantially smaller then the reductions proposed for state agencies and other state services. This initial reduction was then compared to that county's total revenues as stated in the most recent State Auditor report. Again, two separate "caps" were imposed in determining the final aid reduction. These were:

- 3.0% of total revenue for all counties; and
- 2.5% of total revenues for counties with a three-year average levy plus aid growth rate less than 2%.

Once the final aid reduction is determined for each county, the reduction is applied first to the newly created need capacity, and then to anticipated Market Value Credit payments if necessary.

The Administration believes that these reductions can and should be absorbed by the counties through spending restraint rather than raising property taxes. To ensure this, the Administration is recommending strict levy limits for CY 04. The Administration recognizes that this may be impossible for some counties, so it is recommending that these levy limits could be superceded by referendum, as allowed under current law.

Relationship to Base Budget

Aid Name	2004 Base Budget	2004 Governor's Rec	Change	2005 Base Budget	2005 Governor's Rec	Change
Counties						
RESIDENTIAL MV CREDIT	138,843	138,843	-	133,334	133,334	-
HOMESTEAD AGR CREDIT AID-HACA	197,096	134,467	(62,629) -	140,266	18,638	(121,564)
OUT OF HOME PLACEMENT AID	-	-	-	53,313	-	(53,313)
CRIMINAL JUSTICE AID	32,476	32,476	-	33,282	-	(33,282)
FAMILY PRESERVATION AID	23,991	23,991	-	24,591	-	(24,591)
AGRIC MV CREDIT	12,931	12,931	-	12,931	12,931	-
AID TO POLICE & FIRE	12,578	12,578	-	13,899	13,899	-
DNR-PILT (Appr - DNR, Exp - DOR)	*12,457*	*12,457*	-	*12,693*	*12,693*	-
DISPARITY REDUCTION AID	10,212	10,212	-	10,282	10,282	-
PERA AID	8,446	8,446	-	8,446	8,446	-
SUPPLEMENTAL TACONITE AID REIM	4,725	4,725	-	4,842	4,842	-
ATTACHED MACHINERY AID	2,382	-	(2,382)	2,382	-	(2,382)
BORDER CITY CREDIT	1,407	1,407	-	1,549	1,549	-
INDIAN CASINO COUNTY AID	693	693	-	693	693	-
PUBLIC DEFENDER COSTS	492	492	-	505	505	-
EXISTING LOW INC HOUSING AID	186	186	-	233	233	-
DISASTER CREDIT/REV	49	49	-	-	-	-
COUNTY NEED CAPACITY AID	-	-	-	-	110,750	110,750
	458,964	**393,953**	**(65,011)**	**453,241**	**328,859**	**(124,382)**
			-14.2%			-27.4%

The table above shows how all of the county aids categorized as Intergovernmental aids are affected in both years of the biennium by the Governor's recommendation. The table below puts the Governor's recommendation into the overall context of the county's total revenues and total budget.

Governor's Proposed CY 2003 City Aid Reduction
As a Percent of Total County Revenues (OSA)

	Cities	
Percent Change	**Number**	**Percent**
Less than 1.0%	5	5.7%
1.0% --- 2.0%	80	92.0%
At 2.0% cap	2	2.3%
Total	87	100.0%

Average -- 1.6% of total revenues

Governor's Proposed CY 2004City Aid Reduction
As a Percent of Total County Revenues (OSA)

	Cities	
Percent Change	**Number**	**Percent**
Less than 2.0%	6	6.9%
2.0% --- 3.0%	47	54.0%
At 3.0% cap	34	39.1%
Total	87	100.0%

Average -- 2.8% of total revenues

Change Item: TOWN and SPECIAL DISTRICT AID REDUCTION

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	($5,300)	($7,300)	0	0
Revenues	0	0	0	0
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact	($5,300)	($7,300)	0	0

Recommendation

The Governor believes that townships and special districts, like all agencies, programs, organizations, and individuals that depend on state financial resources from the State, must share the burden of solving the current budget problem. All must be prepared to exist with reduced state resources.

The Governor recommends that in the 2004-05 biennium local aid payments to townships be $ 29.1 million. This represents a reduction of $7.3 million or 20%. For townships, this reduction is limited to the Market Value Credit payments. Recognizing that calendar 2003 local budgets are already set, the Governor is recommending that the reductions in the first year of the biennium be limited to roughly one-third of the total. This will give townships additional time to plan for the larger reductions in the second year of the biennium.

The Governor recommends that in the 2004-05 biennium local aid payments to special districts be $30.9 million. This represents a reduction of $5.3 million or 14.6%. For special districts, this reduction is limited Market Value Credit payments.

Background

Minnesota has a long history of supplementing local government revenues with state general fund aid payments. Advocates of state aid payments have advanced several reason for this financial relationship including:

- State aid payments help communities with limited property wealth to provide basic local services without undue property tax burden.
- State aid payments help offset the cost of state mandates.
- State aid payment helps limit overall property tax burden.

Critics of the current aid system have also advanced several criticism including:

- State aid distribution formulas are often not based on need but on historical spending patterns.
- State aid programs do not have specific objectives or accountability measures.
- State aid drive increased spending by local governments not reduced property taxes.

The Administration used percent of total levy as the basis for distributing the cuts as widely and as fairly as possible for both townships and special districts. In FY 04/CY03, the basis was 2.0% of levy for townships and 1.5% of levy for special districts. In FY 05/CY04, the basis was 3.0% of levy for townships, and 2.0% of levy for special districts.

Relationship to Base Budget

Townships:

Aid Name	2004 Base Budget	2004 Governor's Rec	Change	2005 Base Budget	2005 Governor's Rec	Change
Towns						
RESIDENTIAL MV CREDIT	12,977	10,077	(2,900)	12,715	8,315	(4,400)
AGRIC MV CREDIT	4,563	4,563	-	4,563	4,563	-
DISPARITY REDUCTION AID	710	710	-	737	737	-
PERA AID	42	42	-	42	42	-
AID TO POLICE & FIRE	18	18	-	18	18	-
	18,310	**15,410**	**(2,900)**	**18,075**	**13,675**	**(4,400)**
			-15.8%			-24.3%

Special Districts

Aid Name	2004 Base Budget	2004 Governor's Rec	Change	2005 Base Budget	2005 Governor's Rec	Change
Special Districts						
RESIDENTIAL MV CREDIT	12,278	9,878	(2,400)	12,098	9,198	(2,900)
LOCAL POLICE & FIRE AMORT AID	3,008	3,008	-	3,008	3,008	-
AID TO POLICE & FIRE	923	923	-	1,021	1,021	-
PERA AID	685	685	-	685	685	-
AGRIC MV CREDIT	662	662	-	662	662	-
BORDER CITY CREDIT	567	567	-	619	619	-
	18,123	**15,723**	**(2,400)**	**18,093**	**15,193**	**(2,900)**
			-13.2%			-16.0%

LOCAL GOVERNMENT AIDS

Change Item: REPEAL USED OIL FILTER REFUND PROGRAM

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	(50)	(50)	(50)	(50)
Revenues	0	0	0	0
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact	(50)	(50)	(50)	(50)

Recommendation

The Governor recommends that the Used Oil Filter Refund Program be ended as part of the overall reform and reduction of local government aids and credits. The program is outside of the core mission of the Department of Revenue.

Background

This program, enacted in Laws of Minnesota 1998, Chapter 389, Article 16, Section 16, was created as a supplement to a used oil reimbursement program operate by the commissioner of the pollution control agency. The reimbursement program is funded from the contaminated used motor oil reimbursement account in the environmental fund.

This refund program is operated by the commissioner of revenue. It is limited to 200 applicants with a maximum refund of $250. Though it is grouped with local aids and credits within the general fund balance, it is actually a payment to individuals and businesses. This program is a “refund” in name only. The refund is not tied to a specific tax. In fact, while the petroleum related taxes and used oil fees are generally dedicated to special funds, these payments are made from the general fund. It is probably more appropriate to consider this a grant program rather then a refund program.

Relationship to Base Budget

This program is a tiny portion of the local aids and credit budget. It’s $100,000 biennial cost is less than 0.01% of the over $3 billion the state spends on local aids and credits.

Statutory Change: MS 325E.112, subd. 2a. repealed.

Background

The Governor's budget proposal includes several changes to state reserves and tax law. The table found below summarizes the items in the Tax Bill. Detailed change items describing these proposals can be found in the following pages.

Some tax-related items can also be found in other parts of the budget. Changes to the dedication of a portion of the Motor Vehicle Sales Tax (MVST) are discussed in the Department of Public Safety budget. Changes in the Health Care Access Fund and its consolidation into the General Fund are discussed in the Human Services budget.

Governor's FY 2004-2005 Proposal
($ 000s)

General Fund:	**FY 2004**	**FY 2005**	**FY 2006**	**FY 2007**
June Accelerated Sales Tax: Make permanent	$150,600	$9,000	$12,600	$12,200
Cigarette Tax: Change Disposition Effective 6/30/03 (FY 2004)	($22,562)	($22,597)	($22,633)	($22,668)
Lottery In-Lieu Tax: Change Disposition Effective FY 2004	$3,194	$3,194	$3,194	$3,194
Transfer Medical Education Endowments to General Fund for Reserve	$1,029,071			
Tax free Zones (JOBZ)	($1,635)	($4,067)	($4,067)	($4,797)
General Fund Total	$1,158,405	($15,273)	($11,163)	($12,463)
Other Funds:				
Change Disposition of Cigarette Tax				
Minnesota Future Resources Fund	($7,138)	($7,103)	($7,067)	($7,032)
Academic Health Center Special Revenue Fund	$21,450	$21,450	$21,450	$21,450
Medical Education/Research Costs Special Revenue Fund	$8,250	$8,250	$8,250	$8,250
Change Disposition of Lottery In-Lieu Tax				
Game and Fish Fund	($1,597)	($1,597)	($1,597)	($1,597)
Natural Resources Fund	($1,597)	($1,597)	($1,597)	($1,597)

Change Item: CHANGE IN LOTTERY IN LIEU DEPOSITS

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	0	0	0	0
Revenues	3,194	3,194	3,194	3,194
Other Fund				
Expenditures	0	0	0	0
Revenues	(3,194)	(3,194)	(3,194)	(3,194)
Net Fiscal Impact	0	0	0	0

Recommendation

The Governor recommends that the portion of the payment made by the State Lottery to the Department of Revenue in lieu of sales tax on lottery tickets now deposited in the general fund be increased from its current 12.9 percent to 26 percent. This change means that the special funds now receiving the benefits of this dedication will be facing a reduction of approximately 15% annually.

Background

Under current law, Lottery game retailers do not collect and remit sales tax on lottery game tickets at the point of purchase. Instead, the Lottery makes monthly payments of 6.5 percent of its total ticket sales directly to the Department of Revenue "in lieu of sales tax." Currently this amounts to about $30 million annually.

The statute also has a formula for how these in lieu of sales tax payments must be allocated and deposited to specific funds. Currently, 12.9 percent is deposited in the general fund and 87.1 percent is distributed, under formula, to several special purpose natural resources funds. These funds include the Heritage Enhancement Account, State Parks and Trails, Metro Parks, Local Trails, and a fund for selected zoos.

Relationship to Base Budget

The Governor is recommending that the portion deposited in the general fund be increased from 12.1 percent to 26 percent. This will increase non-dedicated general fund revenues by $3.2 million annually.

Revenues going to the other funds will be decreased by a like amount. There is no change being recommended for the distribution formula among the other funds, therefore, each of the individual natural resource funds will take a proportional share of the overall reduction. This change will require spending reductions of approximately 15 percent in these dedicated funds. This reduction is comparable to what most state agencies are facing in their general fund operations.

Activities recommended in these specific natural resource areas under the reduced funding levels are discussed in more detail in the Natural Resources budget presentation.

Statutory Change: MS 297A.94

Change Item: DELAY REPEAL OF JUNE ACCE SALES TAX

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	0	0	0	0
Revenues	150,600	9,000	12,600	12,200
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact [1]	(150,600)	(9,000)	(12,600)	(12,200)

Recommendation
The Governor recommends that the expiration of the accelerated June sales tax payment, now scheduled for June 2004, be delayed permanently.

Background
Under current law, businesses generally pay their sales tax obligation to the Department of Revenue by the 15th of the following month. However, certain businesses that collect sales tax are required to pay 75% of their estimated June obligation two business days before the end of the month. The June 2003 sales tax obligation was intended to be the last payment covered under this policy.

Relationship to Budget
This change means that FY 04 sales tax revenues will be increased over the expectation in the current forecast. In future year, expected growth in overall sales tax revenues creates positive revenue “tails.”

Statutory Change: MS 289A.20, subd. 4

[1] Net fiscal impact equals expenditure change minus revenue change. Positive numbers can be expenditure increases or revenue decreases. Negative numbers can be expenditure reductions or revenue increases.

Change Item: JOB OPPORTUNITY BUILDING ZONES

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	135	57	57	57
Revenues	(1,500)	(4,010)	(4,040)	(4,740)
Other Fund				
Expenditures	0	0	0	0
Revenues	0	0	0	0
Net Fiscal Impact [1]	1,635	4,067	4,097	4,797

Recommendation
The Governor recommends the establishment of several Job Opportunity Building Zones in economically depressed areas of the state. The program, called JOBZ, will establish specific geographical areas where taxes will be waived as an economic development tool.

Background
The plan would be to give businesses operating in these JOBZ areas an exemption from state and local property taxes, corporate franchise tax and sales tax exemptions certain business related purchases. People who live in the zones would be exempted from property taxes, and people who work in the zones would be exempt from state income tax. The JOBZ proposal is modeled on plans recently enacted in Pennsylvania and Michigan.

Up to ten JOBZ zones would be located primarily in greater Minnesota. They would be both geographically and time limited. A proposal and selection process would be used to select the initial JOBZ zones. At the end of the tax exemption period, it is hoped that permanent business and job development, and the increased tax revenues it would produce in the future, will offset the temporary revenue losses.

The details of the plan are still being developed and will be released as a separate bill and initiative at a later date.

Relationship to Base Budget
The financial implications of this proposal are still being analyzed. The numbers presented above are the best estimates available at this time (based on HF 3). They recognize that there will be a small state cost related to establishing and monitoring the zones, and in granting and monitoring tax exemption activities. Under budget scoring rules, there will be a negative general fund revenue impact because taxes currently specified that would be paid by a new business would be waived. The exact extent of this revenue loss is highly speculative.

Key Measures
- Number of zones established.
- Number of new business startups in those zones
- Employment and property value growth.

Statutory Change: Several specific exemptions to the current tax law will be presented.

[1] Net fiscal impact equals expenditure change minus revenue change. Positive numbers can be expenditure increases or revenue decreases. Negative numbers can be expenditure reductions or revenue increases.

Change Item: TRANSFER ENDOWMENTS AND DEDICATE CIGARETTE TAX

Fiscal Impact ($000s)	FY 2004	FY 2005	FY 2006	FY 2007
General Fund				
Expenditures	0	0	0	0
Revenues				
Transfer from Medical Education Endowments	1,029,071			
Dedication of Cigarette Tax	(22,562)	(22,597)	(22,663)	(22,668)
Other Fund				
Expenditures	0	0	0	0
Revenues				
MN Future Resources Fund	(7,138)	(7,103)	(7,067)	(7,032)
Academic Health Center at U of M	21,450	21,450	21,450	21,450
Medical Educ. Research at Dept of Health	8,250	8,250	8,250	8,250
Net Fiscal Impact [1]	(1,029,071)	0	0	0

Recommendation

The Governor recommends that the $446.682 million currently in the Tobacco Use and Prevention Endowment and the $582.389 million currently in the other medical education endowments be transferred to the General Fund in FY 2004.

The Governor also recommends that the $0.02 per pack dedication of the cigarette tax now directed to the Minnesota future resources fund be repealed and be directed to the General Fund. Beginning July, 2003 the Governor recommends that $0.065 of the per pack tax be dedicated to fund the work of the Academic Health Center at the University of Minnesota, and that $0.025 of the per pack tax be dedicated to fund medical education and research activities at the Department of Health. This will help ensure a consistent funding stream for the programs in the future.

Relationship to Base Budget

The Governor is recommending that the $446.682 million currently in the Tobacco Use and Prevention Endowment and the $582.389 million currently in the other medical education endowments be transferred to the General Fund in FY 2004.

It is anticipated that the $0.065 dedication of the cigarette tax will generate $21.45 million annually for medical education activities at the Academic Health Center, and the $0.025 dedication of the cigarette tax will generate $8.25 million for medical education activities at the Department of Health. The activities that will be funded by the dedicated funding sources are discussed in greater detail in the Higher Education budget document and the Health and Human Services budget document. This budget page presents only the tax implications of this budget item.

Statutory Change: 297F.10, subd. 1.

[1] Net fiscal impact equals expenditure change minus revenue change. Positive numbers can be expenditure increases or revenue decreases. Negative numbers can be expenditure reductions or revenue increases.