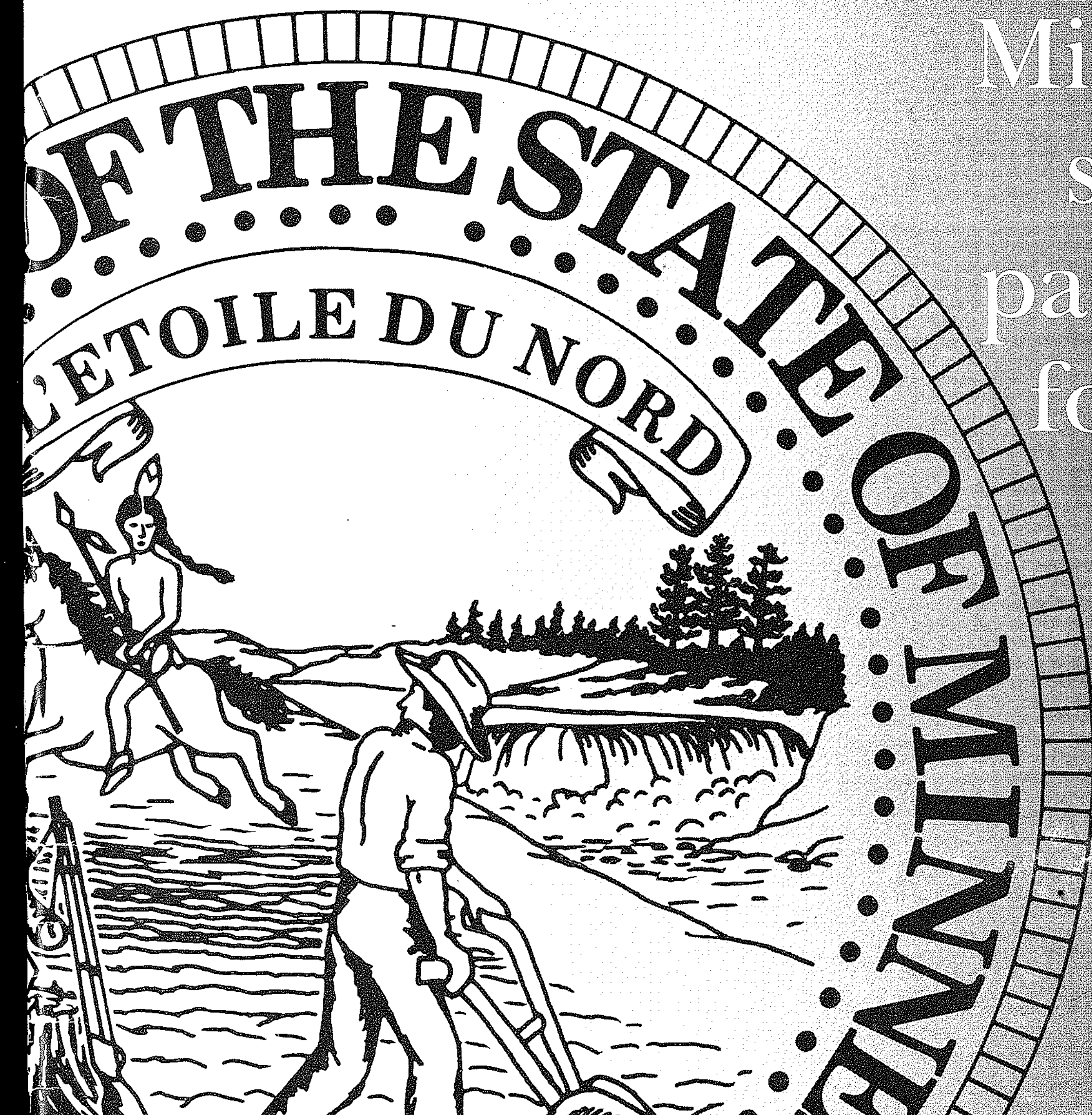

Minnesota's state-local partnership for the 90s

Property tax and local aids reform plan

Governor Rudy Perpich
August 1989

RUDY PERPICH
GOVERNOR

STATE OF MINNESOTA

OFFICE OF THE GOVERNOR

ST. PAUL 55155

August 10, 1989

To: Members of the Legislature and Citizens of Minnesota:

I am pleased to present to you my plan for property tax and local aids reform, *Minnesota's State-Local Partnership for the 90s.*

Over the past several months, we in the Administration have heard from many Minnesotans. They questioned why their property taxes are growing so fast and why they can't understand our system, and they asked us to get on with the job of reforming it now.

This plan responds to their concerns and is truly a "partnership for the 90s." It is a partnership because it demands that both state and local governments redefine how they deliver and pay for public services. Under this partnership, state tax dollars would pay for those programs that the state requires local governments to deliver. Local governments would pay for local spending decisions. This restructuring will increase government accountability and will help to control government spending.

This plan is for the 90s because it takes the decade to fully implement. We did not get into this property tax mess overnight, and we cannot get out of it in one legislative session. But we can chart our course now toward long-term reform and take a big step in the right direction. If we don't begin immediately, I firmly believe we will face a fiscal crisis within two to three years.

Although the tax bill passed by the 1989 Legislature did not focus on long-term reform, it did provide meaningful relief to those property tax payers who are suffering most under the current system. I am pleased that our plan provides the same $274 million in relief for 1990 and that it targets that relief to the same three classes: mid- and high-value homes, rental residential, and business property. In addition, our plan eliminates disparities in the system over the next decade.

I urge your support for *Minnesota's State-Local Partnership for the 90s.* It provides needed short-term relief, and it provides a roadmap for needed long-term reform.

Sincerely,

Rudy Perpich

RUDY PERPICH
Governor

Minnesota's state-local partnership for the 90s

Governor's property tax and local aids reform plan

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Executive summary

Minnesota's property tax and local aids systems need comprehensive reform. Patching problem areas, as has been done in the past, has produced only temporary relief, usually to only a few classes of property, while making the system as a whole worse. The state-local partnership plan that Governor Perpich proposes will start Minnesota on the road to reform, and will correct the deficiencies in the state's property tax and local aids systems.

The governor's plan is based on five beliefs:

- Our property tax has become unfair. Major reductions in property taxes are needed *now* for mid- to high-value homes, and for residential rental and business property.
- Our property tax has grown too large. Its share of Minnesota's total state and local taxes should be reduced and kept down in the future for the benefit of all property tax payers.
- The inefficiencies in our local aids system discourage spending restraint on the part of government at all levels. We must replace spending incentives with encouragement for spending restraint.
- The roles of state and local governments in the financing of public services are confused. They should be complementary, and the fiscal responsibilities of each must be clarified. The state should use statewide taxes to pay for programs it mandates, and local governments should use local taxes to pay for local spending decisions.
- Our property tax and local aids systems are incomprehensible. We need to make them understandable so that citizens, local government officials and legislators can make well-informed decisions.

Minnesotans need and deserve property tax relief now.

- The plan reduces the size of the local property tax in relation to Minnesota's total state-local taxes, and strengthens its role as a funding source for *local* services.
- The plan provides $274 million to decrease the 1990 overall property tax on existing property by 1.4 percent. This tax relief has a major impact on the property taxes of homes, residential rental property, and business property.

Percent change in property taxes from 1989 to 1990

existing properties only

	current law	governor's plan
Homes	12.1%	-1.0%
Rental housing	9.0	-10.3
Businesses	10.9	0.3
Overall	10.7%	-1.4%

The plan will encourage state and local spending restraint.

- State spending will be restrained because the state will be obligated to pay for its mandates rather than passing the costs back to local governments.

- State spending will be restrained by the sunsetting of more than 80 state aids and mandates, with continuation of those programs dependent upon thorough review and legislative re-enactment.
- State and local spending will be restrained because proposed future state mandates will have to go through a rigorous cost analysis before enactment.
- Local spending will be restrained because state aids will no longer pay for a substantial portion of local spending decisions.
- Overall spending restraint will be encouraged by increased understandability of the overall system and better monitoring and reporting techniques.

The plan is a blueprint for restoring fairness to our system.

- There will still be disparities in local tax rates, but they will be narrowed, and will relate more to local spending choices and less to differences in property wealth.
- Unfair disparities between the highest and lowest taxed classes of property will be ended by reducing the current ratio of 13:1 to 4:1 by 1996, and to 3:1 by 1999.
- Unfair disparities between the lowest and highest home taxes will be ended by 1991, when no home will have a class rate of less than 1 percent, nor more than 2 percent of its value.
- Unfair disparities between rental housing and homestead property will be ended by gradually lowering rental housing rates to 2 percent by 1996.
- Unfair disparities between business property and other classes will be ended by lowering business tax rates to 5 percent in 1990, with gradual reductions to 4 percent by 1996, and 3 percent by 1999.
- Relief to homeowners and renters will emphasize the income-adjusted property tax refund program, which will grow by indexing factors each year.
- State aid to cities will be directed to cities having the greatest community need.

The plan will clarify the fiscal responsibilities of state and local governments.

- In 1990, $958 million of currently undesignated state aids are converted to state support for mandated programs in human services, education and the courts, and to a single, need-based city local government aid formula.
- Between 1991 and 1995, $127 million of undesignated aids

will be converted to state support for other human services and courts programs.

- Between 1990 and 1993, more than 100 additional state aids and mandates will be reviewed for possible funding conversion, repeal, or other improvement.
- A new Commission on Intergovernmental Finance will be created to help implement the plan and to seek further improvements in state-local fiscal relations.

Local governments will have needed flexibility in financing local needs, but they will be more accountable for local decisions.

- Cities will have greater revenue-raising flexibility through four local option revenue sources: a general sales tax, service fees on tax-exempt property (other than constitutionally exempt property), the removal of statutory limits on hotel-motel taxes, and utility franchise fees.
- State payment of state mandates will free up property tax base for local use.
- City levy limits will be repealed in 1991; county levy limits in 1993.
- Truth-in-taxation notices and property tax statements will clearly show year-to-year proposed and actual tax obligations imposed by each governmental unit.
- Improved reporting of local government finances will facilitate increased public understanding of local spending and taxing.

The plan will make Minnesota's property tax and local aids systems more understandable.

- The number of property tax rates will drop from the current 21 to nine in 1990, to four in 1996, and to three in 1999.
- By 1996, all class rates will be expressed in whole number percentages: 1, 2, 3, and 4 percent in 1996, and 1, 2, and 3 percent in 1999.
- Fewer state aids and mandates, and a single city local government aid formula will promote taxpayer understanding.

The plan will be financed within current resources, future revenue growth and future cost reduction efforts.

Background

The services provided by Minnesota's cities, towns, counties and schools are financed through three principal taxes: state-collected income and sales taxes, and the local property tax. More than 63 percent of these state-collected revenues are used to finance services provided by local governments.

As early as 1984, the governor directed his tax advisors to examine these three major tax types in an effort to make the entire system fairer and more understandable. Since then, Minnesota's income tax has undergone major reform to make it fairer and simpler to understand. Likewise, the equity of the sales tax has been improved.

However, progress on reforming the property tax and local aids systems has been slow and elusive, in part because of their sheer complexity, and because of the scope of the problems:

- The staggering complexity of these systems prohibits even the most conscientious citizens and their elected representatives from understanding them.
- The property tax system imposes an ever-increasing tax burden on already heavily taxed income-producing properties; this burden contributes to shortages of affordable, well-kept and safe rental housing, and threatens to hamper the expansion of the state's economy.
- Our haphazard and increasingly expensive system of joint state-local financing of local government services diffuses responsibility and makes it virtually impossible for citizens to know whom to hold accountable for spending and taxing decisions affecting their property tax bills.
- The interlocking nature of the systems creates incentives for more spending, by both state and local government.

Many have called for reform of the property tax system. In 1984, the Governor's Tax Study Commission recommended a three-class property tax system with a restructuring of state aids to local government. Other recent calls for reform have come from the Citizens League, the Hubert H. Humphrey Institute of Public Affairs at the University of Minnesota, and the Minnesota Taxpayers Association.

The tax bill passed in the 1989 regular legislative session would have provided immediate and much-needed property tax

State funds for local spending in fiscal year 1989
(millions of dollars)

Aid to counties	**$ 880.4**
Aid to cities and towns	**338.8**
Aid to schools	**1,639.3**
Property tax credits and refunds	**850.7**
TOTAL	**$3,709.2**
Percent of state budget	**63.1**

relief for some owners of heavily taxed property. But the bill did not address the systems' fundamental, long-standing problems.

Minnesota is now at a crossroad. The choice is to continue putting resources into short-term relief, or to begin now to take the steps needed to reform the property tax and local aids systems permanently. Because adequate financial resources exist, we have a unique opportunity to launch this effort. To spend that money and fail to begin major reform would be a turn toward fiscal disaster.

Advice from Minnesotans on Property Tax and Local Aids

Consultations with the citizens of Minnesota on the subject of property tax reform were held by the governor and members of his administration during the spring and summer of 1989.

The most extensive part of this consultative process was a series of ten public hearings on the property tax and local aids systems held throughout the state in June and July. Governor Perpich, along with Lieutenant Governor Marlene Johnson, heard testimony from more than 300 people who relayed their personal experiences, frustrations, and concerns with the current systems. Over 2,000 people attended the hearings to listen and learn, while yet another 2,000 sent in written comments to the governor. Homeowners and renters, landlords and property managers, business owners and managers, farmers, cabin and timberland owners testified, as did local government officials and legislators.

In Duluth, Rochester, Bemidji, Brooklyn Park, Worthington, Minneapolis, St. Cloud, Moorhead, Marshall, Bloomington, and St. Paul, the message is the same: *Our system is no longer working for citizens or government, and it's getting worse.*

The most frequently expressed concerns were in three major areas:

- Property taxes on rental housing are too high.
- Business property taxes are also too high.
- Minnesota's property tax and aids systems are too complex.

Over and over, the people told state officials of the serious consequences these factors are having on their lives. Here's what they said:

In regard to rental housing, landlords said that from 20 to 40 percent of the total rent they receive goes to pay property taxes. As a result, low- and moderate-income persons face shortages in affordable rental housing, because low profit margins resulting from high property taxes discourage investment in rental housing. And in many cases, landlords find themselves delaying or canceling maintenance and repairs.

"We need to get away from sending dollars to places and send them to people."
—Twin Cities elected official

"It is clear that the general public does not understand the current property tax system, leading to frustration on the part of both the taxpayers and policy makers."
—county commissioner, Northeastern Minnesota

"Let's structure property taxes to encourage investment dollars in our communities, not discourage them."
—Worthington business owner

"Property taxes are killing me. They are now 12 percent of my income; two years ago they were $1100, and now they are $2500. It's not fair."
—Twin Cities area homeowner

"Taxes are the single biggest expense in managing rental housing."
—Minneapolis apartment building manager

"With such a large share of any income from rental properties going to property tax, it is hard to just maintain and almost impossible to do any upgrading that needs to be done."

—Rochester landlord

"It's not the big commercial developers that pay taxes in malls; it's the small retailers that rent space."

—Twin Cities merchant

"We don't mind paying our fair share; all we're asking for is a chance to be competitive."

—St. Paul business owner

"Between 1981 and 1989, our customers saw a 45 percent increase in new car prices, but our 126 percent increase in property taxes gives a new meaning to the term 'sticker shock!'"

—Twin Cities auto dealer

"I've heard different stories on how valuations are determined; as a homeowner, I'm entitled to a straight explanation on how this system is set up. The lack of direct information on this subject is appalling."

—Twin Cities area homeowner

"I believe that local city councils with public input and public support are better able to make decisions regarding what our property taxes should be than elected officials in St. Paul.

"We know what our needs are, and should have the flexibility to deal with those issues."

—Southwestern Minnesota mayor

Minnesota's business owners and managers said their high property taxes put them at a disadvantage when competing with businesses in other states. Business property taxes are two to three times as high as most other states for retail stores and warehouse facilities, and higher than any bordering state.

Repeatedly, state officials were told that high property taxes discourage our businesses from expanding and new businesses from moving into the state. There was also testimony that taxes have been a major factor in some businesses' relocating to other states. Business people and government officals alike were concerned that property taxes for businesses mean fewer jobs, higher product prices, layoffs, and impairment of Minnesota's economic growth.

Considerable concern was also expressed in three other areas:

- Property taxes on higher valued homes are too high.
- Poorer communities need state aid to even out the tax burdens of providing needed services.
- Local units of government need prompt action on tax legislation so 1990 plans can be set.

Testimony was also given about property taxes on cabins, forest land and farm land, and about the need to control spending if taxes are to be held to reasonable levels.

Citizens and local government officials said that simplifying the property tax system and clarifying the roles of state and local governments in tax collection and public spending would encourage a better understanding of government in Minnesota.

Principles and goals for reform

Each unit of government in Minnesota, from town to city, from county to state, exists for one reason only: to serve the needs of its citizens. Different levels of government are constituted to meet different needs, with cities and towns addressing local needs, while the state addresses concerns that cross local borders. Together, they form the network of service and structure that we mean when we say "good government."

All of these units join in partnership to serve the people of Minnesota. In recent years, however, the roles of different levels of government in Minnesota have become confused. State mandates shape local services; local governments rely on state aids to help fund local needs. With the confusion of roles has come confusion of resources. And the result is that our present systems of property tax and state aids–the resources we rely on to meet our citizens' needs–have grown ever more complex, inefficient, and unintelligible.

Few, if any, question whether Minnesota needs property tax and local aid reform. In fact, our current systems have been subject to almost continuous efforts to improve them for a number of years.

The governor's plan, however, does more than improve the property tax and local aid systems. It also lays the foundation for a major restructuring of the relationships among these units of government.

The restructuring is based on this simple idea: that local governments should use taxes raised locally to pay for local spending decisions, and state-mandated programs should be paid for by taxes raised on a statewide basis. Local governments will continue to rely on the property tax, and the state will continue to fund many of the same programs it does now, but the ways in which these units of government interrelate will be easier to understand, more efficient to administer, and as a result, fairer and less costly for everyone.

A fair system recognizes that all citizens of the state are entitled to a certain basic level of local services, whether or not the communities they live in are able to raise the funds to pay for them. The system must acknowledge differences in ability to pay for needed services. State-paid property tax relief should be based on this "ability to pay" principle, with property tax refunds going directly to individuals with lower incomes, and state aids going to local units of government whose fiscal capacity is low in relation to their citizens' needs.

Fairness also calls for reducing the differences between property tax rates applied to different types of property. In Minnesota in 1989, the highest rates specified in law are thirteen times as high as the lowest, before taking into account differences in local tax rates. Those differences can increase the spread to twenty to one, or more.

Different rates have been justified by the fact that the highest rates generally apply to income-producing property, such as rental, commercial and industrial property. But the taxes on rental housing are among the highest in the nation, and they are passed through to renters, who often lack the income to pay high rates. The "ability to pay" principle would be better honored by reducing the differences in the ways that rental and owner-occupied housing are treated.

Our property tax on business real estate is also among the highest in the nation. Lower rates for business properties would increase the attractiveness of Minnesota to new investment and new jobs, and help us retain the businesses we already have, especially in the areas near our neighbor states.

One major–and justifiable–criticism is that state aid formulas, rather than helping to hold down local costs, actually have rewarded local units of government for spending increases with increased payments. Similarly, the tendency of state government to mandate, but not fund, local programs has tended to increase property taxes. Restructuring the system so that each governmental unit is responsible for the costs of the programs it establishes will encourage spending restraint at all levels of government. In short, both state and local governments are likely to be more careful about authorizing new expenditures if they are required to raise taxes to pay for them.

Another criticism of our current system is that it is too hard to understand. Indeed, a system must be understandable, or citizens will not be able to participate in or make informed decisions about it. The current system is so incomprehensible in part because of the number and complexity of our property tax classes (29 separate classes), and because of the number of different aid programs (well over 100) that go to fund every type of service at every level of government. One way to help ensure fairness is to simplify the classification system and realign program funding responsibilities so that citizens can understand–and monitor–both taxing and spending.

Making the system more understandable by simplifying it and clarifying the roles of different levels of government will improve the efficiency of government. These changes will also help the government officials who administer the system do a better job.

Some pressure on the property tax would be removed if the state paid for more of the programs it mandates. But cities may also need alternative sources of revenue. Even communities with the most cost-efficient governments often face high property taxes coupled with reduced state aids. To relieve these pressures, communities should have the discretion to raise revenue from non-property sources.

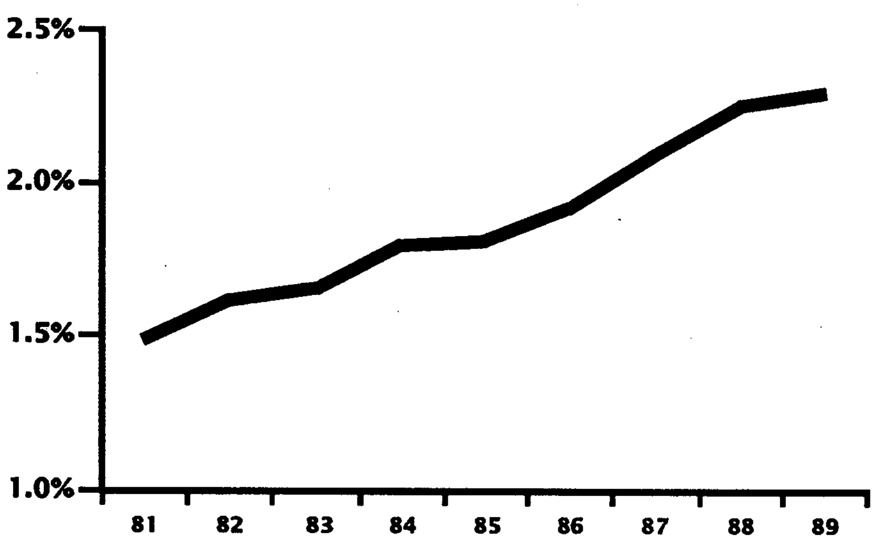
We must remember that the property tax is only one component in the complex system of state and local revenue-raising. Our property tax has grown too large in our mix of taxes; its share should be reduced and kept down in the future for the benefit of all taxpayers.

Property Tax Reform

The property tax, raised and spent exclusively by local governments, is Minnesota's largest tax. The property tax levy was $3 billion in 1989. By comparison, fiscal year 1989 income tax revenue amounted to $2.3 billion and sales tax revenue totaled $1.8 billion.

In 1989, the local property tax surpassed the state's individual income tax as the largest tax in Minnesota, and the property tax is continuing to grow faster than other major taxes. The projected increase for 1990 over 1989 property taxes is $427 million, a 14 percent increase.

Property Tax as Percent of Market Value



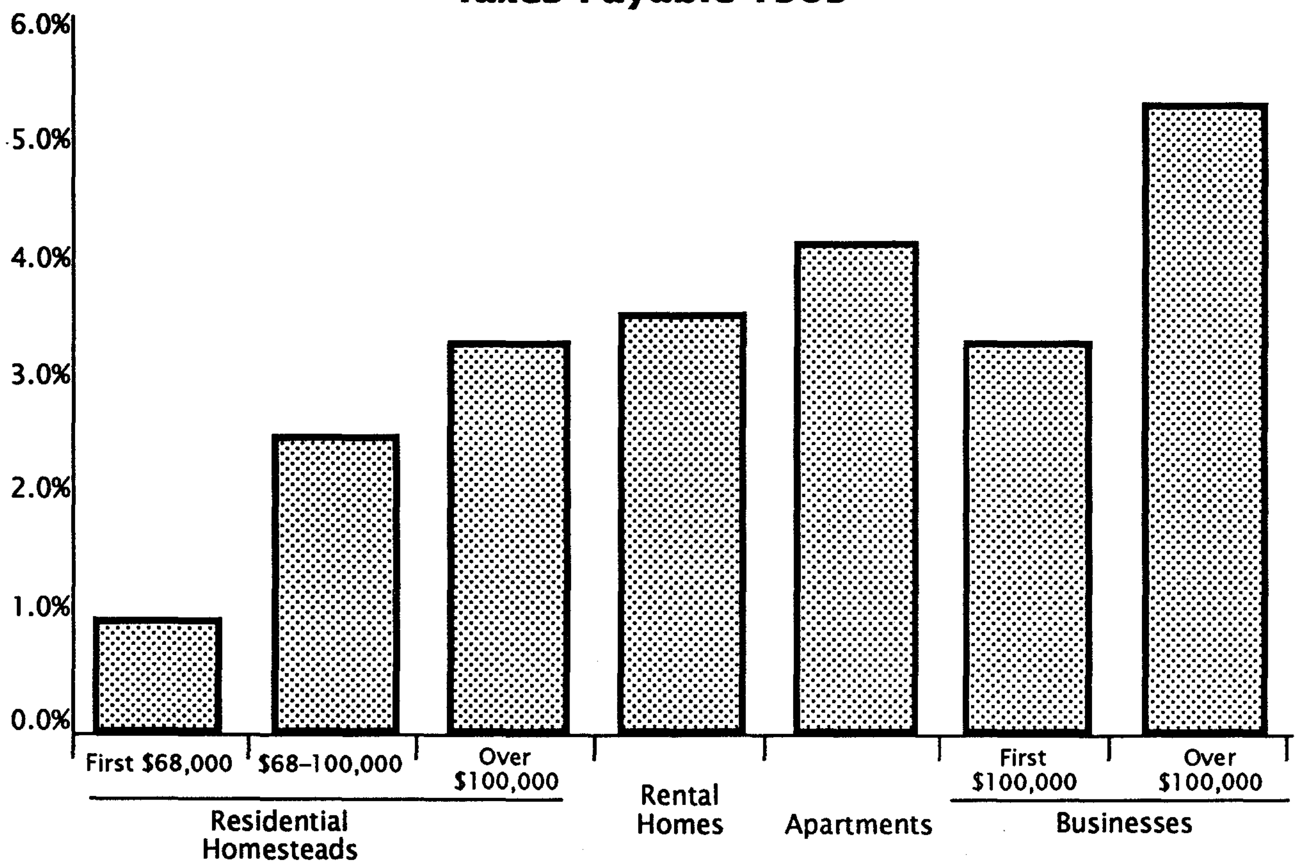
The property tax is also Minnesota's most painful tax. The tax is paid in two, usually large, installments rather than being paid more evenly throughout the year as are income and sales taxes. And, the property tax usually increases as property value increases, which sometimes is not matched by increases in ability to pay.

The high rates on some classes of property add to the pain. While the first $68,000 of home value is taxed at only 1 percent of its estimated market value (making Minnesota 39th among the states for low-valued homes), other homeowners pay much higher rates–up to 3.3 percent on a home's value above $100,000.

Minnesota's renters pay higher rents to their landlords because rental housing is taxed at one of the highest rates in the nation–3.5 percent on single family homes and duplexes, and 4.1 percent on apartments. And business owners also pay property taxes at one of the highest rates in the nation–5.25 percent.

There is also an extremely wide disparity in the tax rates on different types of property. Minnesota's property tax laws prescribe tax rates for different categories of properties ranging from a low of 0.4 percent to a high of 5.25–a ratio of 13 : 1 between the lowest and the highest tax rates. Because of different spending levels by local governments, actual tax rates on property vary by a ratio of 20 : 1 or higher. These variations are the largest in the country and are inherently unfair.

Comparative Statutory Rates by Class
Taxes Payable 1989



Minnesota has 21 different property tax rates and 29 different classes or subclasses of property. Our property tax system leads the nation in incomprehensibility.

Immediate tax reductions and improved fairness in 1990

The governor's plan provides $274 million to reduce property taxes in 1990 on the most heavily taxed property in Minnesota and begins to narrow the wide disparities in tax rates between the different classes of property.

The projected statewide property tax levy of local governments will be cut from $3.465 billion to $3.108 billion or from a 14.1 percent increase down to a 2.3 percent increase over 1989. Since new construction absorbs about 3 percent of the increase in taxes on homes and 4 percent on business properties, the total statewide tax on existing property will actually decrease by about 1.4 percent from 1989 to 1990. And, since market values of properties are generally rising, the statewide effective tax rates of properties should drop even more.

Percent change in property taxes from 1989 to 1990

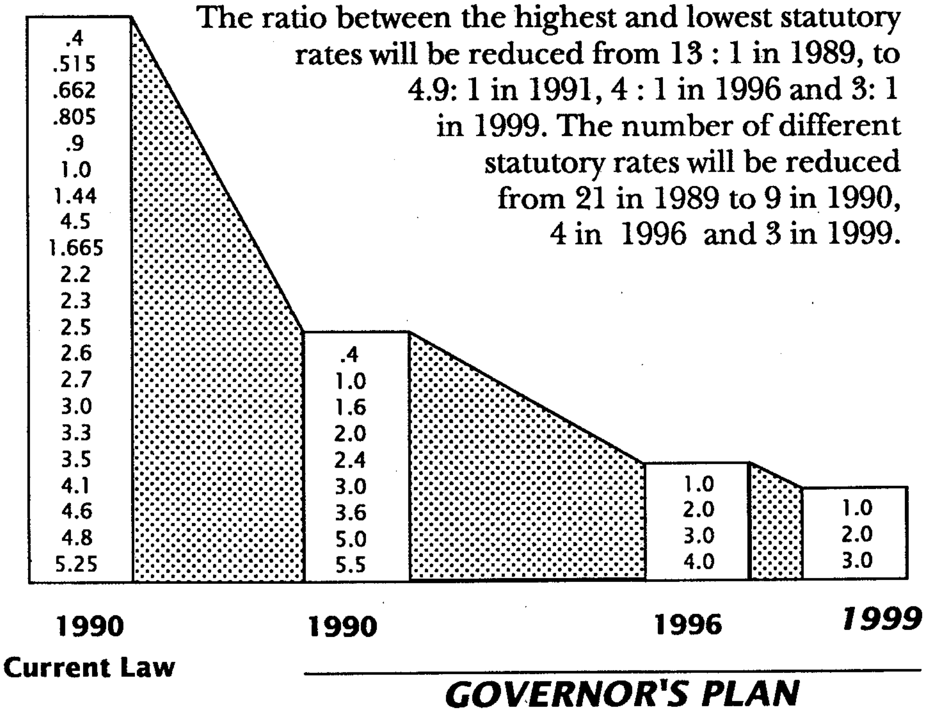
existing properties only

	Current Law	Governor's Plan
Farms	13.0%	2.6%
Homes	12.1	-1.0
Rental housing	9.0	-10.3
Businesses	10.9	0.3
Overall	10.7%	-1.4%

Enhanced fairness and simplification beyond 1990

The governor's plan gradually narrows the disparities in tax rates between property classes and reduces both the number of rates and classes. This will steadily improve the fairness, stability and understandability of the state's property tax system, and Minnesota's competitive position among the states.

The ratio between the highest and lowest statutory rates will be reduced from 13 : 1 in 1989, to 4.9: 1 in 1991, 4 : 1 in 1996 and 3: 1 in 1999. The number of different statutory rates will be reduced from 21 in 1989 to 9 in 1990, 4 in 1996 and 3 in 1999.



The long-term target classes and rates are as follows:

Proposed Changes in Property Tax Rates

	1990 Current Law	GOVERNOR'S PLAN		
		1990	1996	1999
Residential: *				
First $68,000	1.0	1.0	1	1
$68-100,000	2.5	2.0	2	2
Over $100,000	3.3	3.0	3	3
Residential Non-Homestead	3.5	3.0	2	2
Apartments	4.1	3.6	2	2
Businesses				
First $100,000	3.3	3.0	3	3
Balance	5.25	5.0	4	3

* Starting in 1991, the total statutory tax rate on homesteads cannot exceed 2 percent of total market vaue.

To further improve the understandability of the system, various terms used in referring to aspects of the property tax system are changed. For example, the term "tax capacity rate" will be changed to "class rate."

A fairer property tax on housing

The governor's plan will vastly increase the fairness of our property tax on housing. Currently the statutory rates on typical classes of housing range from 1 percent on most homes to 4.1 percent on most apartments. By 1996, the range on all housing will be from 1 percent to 2 percent.

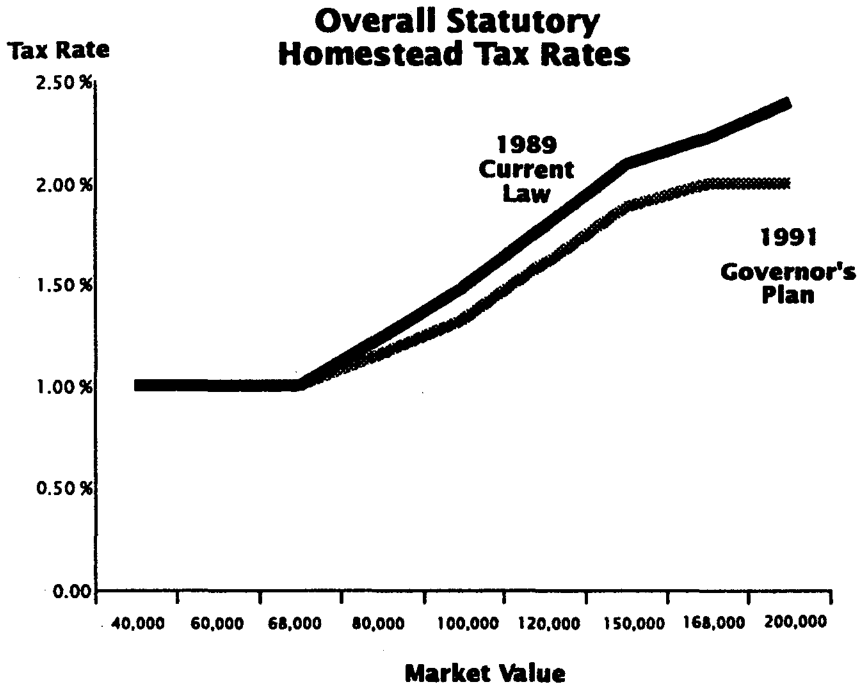
Homes. The governor's plan continues Minnesota's historic policy of helping Minnesotans to own a home by maintaining the bargain rate of 1 percent on the first $68,000 of a home's value. The plan treats a farm home like any other home, enhancing simplicity and fairness of the property tax system.

The plan considerably reduces the rates on higher increments of value which are causing the great property tax pain now

Class Rates for 1990
Residential Homestead Property

	Current Law	Governor's Plan
$ 0 - 68,000	1.0%	1.0%
$68-100,000	2.5	2.0
Over $100,000	3.3	3.0

being experienced by many homeowners. These improvements are effective in 1990. The plan's reform of property taxes on owner-occupied homes is completed in 1991 with the provision that no home will have an overall statutory tax rate of more than 2 percent of its total market value.



Rental housing. Minnesota's high property tax rates on rental housing and the removal of income tax incentives to own and invest in such properties by the 1986 federal income tax reform, are leading to shortages of affordable and well-maintained housing for renters. The governor's plan for reduction in rental property taxes will help to ease the state's shortage of affordable housing, encourage maintenance and rehabilitation of existing structures and stimulate the construction of additional housing for low and moderate income renters. By 1996, the class rate on all rental housing will be 2 percent.

Class Rates for 1990
Rental Property

	Current Law	Governor's Plan
Residential Non-Homestead	3.5%	3%
Apartments	4.1	3.6

Property tax refund program. The governor believes that the state should place greater emphasis on the property tax refund program in providing tax relief to Minnesotans. This program targets state assistance to homeowners and renters based on their ability to pay and thereby helps compensate for a major weakness in the property tax system.

The governor's plan will raise the maximum amount of household income for the refund in 1990 from the current $35,000 to $40,000. The plan continues the state's commitment to the program by indexing both the brackets and the maximum refund amount to inflation in years after 1990.

Special property tax refund (targeting). The governor's plan removes the limit on the maximum refund which can be received by homeowners under the special property tax refund for 1988 to be received this year. At present, the maximum refund is 75 percent of that portion of a property tax increase over 10 percent up to a maximum of $250. Under the governor's plan, the Department of Revenue will automatically recompute all special property tax refunds of $250 and pay the full 75 percent of the portion of property tax increases over 10 percent when it mails refunds to homeowners in late September.

The governor's plan makes permanent the special property tax refund, including the removal of the limit on the maximum amount of the special refund.

A fairer and more competitive business property tax

Minnesota's business property taxes are among the highest in the nation–as much as two to three times as high as most other states for retail stores and warehouse facilities. In addition, owners of businesses have regularly experienced double digit increases from year to year for several years. High real property taxes are repeatedly cited as a major concern of businesses and are believed to be an important element in the decisions of some businesses to leave Minnesota or not to expand here.

Class Rates for 1990
Business Property

	Current Law	Governor's Plan
First $100,000	3.5%	3%
Over $100,000	5.25	5

The governor's plan calls for reducing the high property tax rate on businesses to improve their ability to compete. Also, the proposal will encourage businesses to stay and expand in Minnesota, and out-of-state businesses to locate facilities here.

The reduction of the business property tax rate from 4 to 3 percent, scheduled to occur between 1997 and 1999, is appropriate since business property taxes are unfairly high. However, there are other business tax issues which warrant a thorough review of Minnesota's overall business tax structure. The governor supports such a review.

Farms and timberland. Under current law, several tax rates apply to farmland, depending on the number of acres of the farm, ownership and whether or not it is homesteaded. The governor's plan consolidates the various tax rates into one rate of 1 percent. The new rate of 1 percent of value will result in a tax decrease for some farms, but will actually cause a tax increase for some smaller-sized homestead farms. Such increases will be offset by increased refunds in the regular and special property tax refund programs.

Current law gives each county board of commissioners the option of taxing timberland in either of two ways: as non-homesteaded farmland or based on annual growth of the timber. This results in timber owners paying widely different amounts of tax in different counties due solely to the method of tax chosen by the various boards. Under the plan, the tax rate on timberland will be reduced from 1.6 percent to 1.0 percent. Timberland currently taxed on the basis of the annual growth in trees will continue to be taxed according to this method until present agreements between property owners and county boards expire. These changes are scheduled to go into effect in 1996.

Resort property. The governor's plan changes the tax rates on resort property by increasing the rate on the homesteaded portion of resort property from 0.9 percent to 1.0 percent, which is the same tax rate in effect on the first $68,000 of a home's value. The rate on the balance of a homesteaded resort and other resorts is reduced from 2.6 percent to 2.4 percent in 1990 and gradually reduced to 2 percent by 1994.

Local government financing reform

Each year, about $3.7 billion of state-raised taxes (about two-thirds of the state's nondedicated revenues) are returned to school districts and local governments. These dollars are used to finance local government operations and to hold down property taxes. The money is distributed to local governments through more than 100 complex formulas and aids.

Accompanying the aid programs are many state-imposed mandates on local government operations. Often, state government does not fully fund the costs of these mandates, and local governments must increase property taxes to pay for them. The combined effect of unfunded mandates and proliferating state aids has created a growth in state-local spending that cannot be sustained.

The governor's plan will overhaul this system of state aids and mandates.

The plan untangles the complicated relationship between state and local governments for financing services provided by local governments. The plan shifts state aids away from a series of undesignated aids and toward state funding for programs that the state requires of local governments–that is, "state mandates." At the same time, local governments will be required to pay most of the costs of local spending decisions.

The benefits of this change are many. Both state and local spending will be controlled and fiscal stability will be enhanced. Property owners will more clearly understand which unit of government is accountable for the decisions affecting their tax bills, and they will be better able to make more informed judgements about the level and quality of services they receive in relation to the tax they pay.

This new approach to state-local fiscal relations in Minnesota will create a solid, new framework for the relationship between state government and cities, townships, counties, and school districts, and between each of them and the property tax. Cities will be more independent of state control and more reliant upon their local tax base.

This plan sets forth the most comprehensive review of state and local spending ever attempted in Minnesota. It enacts major redirection of more than $1.1 billion in state spending, and provides for a rigorous study of $3 billion in other programs. By the time this effort is completed in 1993, Minnesota will have a more fair, understandable, stable, rational and accountable state-local fiscal system.

The eight key features of the governor's local aids reform plan are:

1. a more independent role for cities and a more fair and rational method of state assistance for those cities having high needs and low property wealth. This will be accomplished through a single new, need-based city local government aid formula costing $328 million in 1990, gradual freeing up of property tax base to permit greater city use of the property tax, new revenue raising options for cities, and a prompt end to city levy limits.
2. the redirecting in 1990 of $630 million in state funding from undesignated local government aids to state-mandated services, such as education and income maintenance.
3. a four-year schedule–from 1991 to 1994–for redirecting $127 million in other undesignated aids to fund additional state-mandated programs.
4. the establishment of a Commission on Intergovernmental Finance to advise the governor and the legislature on local-state-federal financial relationships.
5. a series of studies by the administration and the new commission of more than 100 aids and mandates for potential elimination, reform or redirection of aid.
6. repeal now, with later effective dates ("sunsetting"), of most of these remaining aids and mandates to encourage legislative action on outdated programs.
7. a requirement that any new state laws or rules which require more local services and result in additional costs be studied for cost impact before implementation.
8. improved reporting about property taxes and local spending to taxpayers and government officials.

More independence for cities

New city LGA formula

The governor's plan includes a new, simple and fair local government aid (LGA) formula for cities. The governor's new formula provides for state payment of $328 million to cities in 1990, with increases in future years determined by increases in the Consumer Price Index (CPI) and household growth. City LGA totaled $376 million in 1989.

The current LGA formulas are defective because they rely so heavily on "grandfathering" of prior aid amounts without reference to need. Under the revised formula in the plan, many more cities will receive state aid amounts determined by the regular formula, and the number of cities "on the formula" will grow steadily.

The new formula contains rules for determining the amount of aid to be received in future years. Fairness will be maintained by indexing the total LGA amount by the statewide CPI and household growth, and by adjusting individual city LGA amounts for changes in the number of city households and property wealth. Spending restraint will be encouraged because the amounts of increase will not be related to city spending decisions.

A city's state aid under the new formula will be determined by:

First, multiplying the total of its 1989 property tax levy and state aid (levy/aid base) by 75 percent. The levy/aid base is limited to $900 per household.

Then, multiplying the total taxable value of a city's property (the net tax capacity) by 12.25 percent, and subtracting the result from the amount in step 1.

The proposed formula is fairer and easier to understand than the current formulas. It takes into account the level of revenue a city now needs to provide services and its ability to provide a basic level of services at reasonable tax rates.

This new approach to support for cities justifies the gradual elimination of undesignated aids such as transition aid. These are being eliminated because they serve only to hold down property taxes; they serve no basic policy goals.

New revenue raising options for cities

Some cities face hardship in meeting local needs with existing revenue sources. The state is limited in its ability to continue raising city aids, and property taxes are already too high in many areas. To meet legitimate city needs, and to help reduce reliance on the property tax, the governor proposes giving cities additional local option revenues.

The plan gives cities the following:

1. authority to add to the state sales tax rate for all sales within city boundaries. The new option tax would be effective January 1, 1991. The tax base would be the same as the state's, and the state would administer the tax.
2. a local option service fee which cities could assess against tax-exempt property owned by non-profit organizations. The fee would be used to cover city costs such as police and fire services. The amount of the fee could not exceed one-half of the normal city levy. Exempt from the fee would be churches and other properties exempt from taxation under the state constitution.
3. the option to raise two taxes above current statutory maximums:
   a. the local hotel/motel tax which is currently limited to three percent, and
   b. the utility franchise tax on electric and natural gas service.

To emphasize again, these local option taxes will be instituted only if approved by the city council. For the sales tax and tax-exempt service fee, citizens would be empowered to overturn the local tax through the "reverse referendum" process.

Prompt end to city levy limits

The governor's plan calls for the repeal of city levy limits effective in 1991. The state will step out of its role as manager of property tax levels through city LGA changes. Instead, city taxing and spending levels will appropriately be determined at the city level by city-elected officials and city voters.

State aid redirection

Stage one: Redirection of state aid dollars in 1990

In addition to the redesigned city LGA formula, the governor's plan for 1990 redirects $630 million in state aid money as a major first step toward funding state-mandated programs with state aid dollars and local discretionary programs with local tax revenues.

Stage One Programs
Funding Restructuring in 1990
(Total fiscal impact–$958 million)

▪ **Redesigned city Local Government Aid formula**	**$328 million**
▪ **Increased state share of K-12 funding and reduction of local school levies**	**$482 million**
▪ **State assumption of county share of income maintenance and court mandates and reduction of county levies**	**$148 million**

The cost of this redirection will be financed by the gradual elimination of undesignated aids now going to local governments. Specifically, the plan transfers $118 million from city and township LGA to school aid and county court funding, and redirects $512 million of transition aid to specific welfare and education programs.

As a result, the state's share of funding for education will increase to about 68 percent, which underscores the state's commitment to K-12 education.

This redirection of local government aid from cities and towns to schools will not lead to higher property tax bills for property owners. Cities and towns will levy a larger share, and schools a smaller share of the same property tax bill. Overall, counties will neither lose nor gain dollars in 1990 under this redirection. However, the redirection will be advantageous to counties in future years, because the state will be paying for programs which are likely to grow in costs, while county transition aids is now frozen at current levels.

Stage two: Additional redirection of state dollars

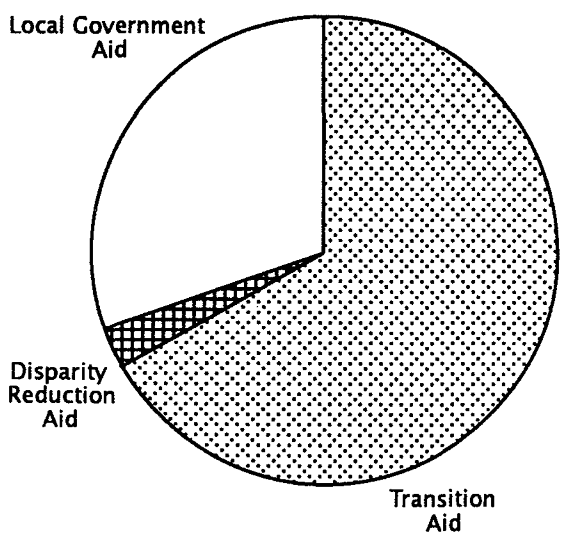
The plan also provides that from 1991 to 1994 the state redirect state aid dollars now provided for general purposes in the form of undesignated aid to pay for the cost of various county

Stage Two Programs
Funding Restructuring in 1991–94
(Total fiscal impact–$127 million)

▪ **State assumption of county share of various human services programs and reduction of county levies**	**$108 million**
▪ **Completion of state takeover of district court funding and reduction of county levy**	**$ 14 million**
▪ **State assumption of city costs of national and state elections and reduction of city levies**	**$ 5 million**

Prior to implementation of each stage 2 program, studies will be required on specific issues, such as methods to insure county cost efficiency.

Redirecting $1.1 Billion in State Aids (Stages 1 and 2)



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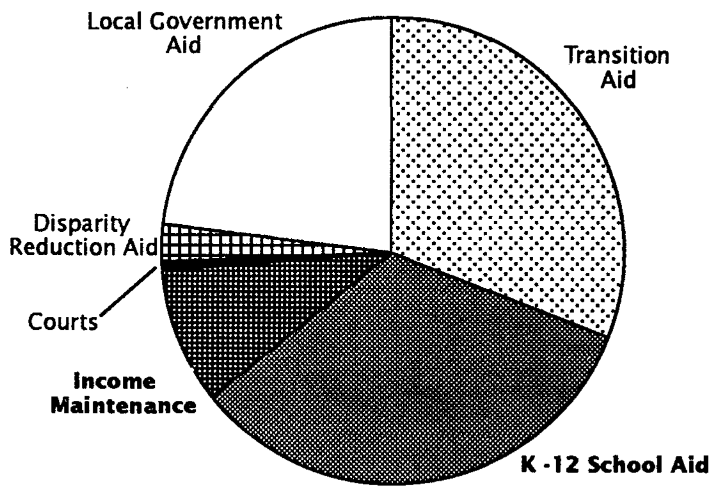

Governor's Plan

Stage Three: Studies and sunsets of remaining state aids

Remaining state aids and mandates covering more than 100 programs are set aside for future study. For these programs, there is as yet no clear plan for funding redirection. Careful analysis is needed for these before any redirection should take place, and the plan provides for a detailed review process to occur between 1991 and 1994. The 100 aids and mandates are divided into four main categories, and a schedule is provided for review and recommendation to the legislature.

Sunset of aids and mandates

More than 80 of the 100 aids and mandates included in Stage Three will be repealed or "sunset" by the plan in the year of scheduled legislative action. This sunset will help to ensure careful review of the programs by the legislature. It will encourage the final elimination of programs that have proven too costly or that have outlived their usefulness. This sunset feature of the plan is critical to its overall success.

Stage Three Programs
Fiscal and Policy Studies in 1991-1994

Total potential fiscal impact-$2.6 billion
Total potential savings from sunsets-$550 million

- **6 local government and special tax provisions, to be studied in 1991 for possible legislative action in 1992**
- **13 human and social services programs and court services, to be studied in 1991 for possible legislative action in 1992**
- **36 elementary and secondary education programs, to be studied in 1992 for possible legislative action in 1993**
- **65 general government aids and mandates, to be studied in 1993 for possible legislative action in 1994**

Commission on Intergovernmental Finance

The plan calls for the immediate establishment of a Commission on Intergovernmental Finance. The commission will consist of 16 members– five from each house of the legislature and six appointed by the governor. The commission will study and recommend which state-mandated programs the state should finance with state aid dollars in the future and which should be allowed to sunset or be modified. The commission will issue recommendations to the legislature in 1992, 1993, and 1994.

The governor's plan requires the commission and governor to review the Stage Three aids and mandates. Each program is to be reviewed for possible funding redirection, depending on such factors as the degree of specificity of the mandate and the estimated impact on cost efficiency of redirection. In addition, the plan sets target numbers for aids in each category after the review process is completed.

Review process for new mandates

The plan also establishes requirements affecting proposed new state mandates on local government. It provides that future proposed mandates undergo a rigorous financial estimating process before being enacted.

This analysis must determine not only state costs associated with the mandates, but also levy impacts on local government units themselves. The Commission on Intergovernmental Finance and the state's Commissioner of Finance are charged with overseeing this process. The procedure means a more cautious approach to creating mandates, and thereby helps to promote spending restraint.

Improved reporting of information about property taxes and local spending

It is impossible in an endeavor of this magnitude to make intelligent decisions without adequate information. The extreme complexity and the lack of crucial information about Minnesota's property tax and local aids system have hampered decision making by taxpayers and government officials. To help remedy this problem, the governor's plan emphasizes improved gathering and reporting of information about property taxes and local spending.

"Truth in Taxation" provisions will advise citizens of proposed property tax increases before they become final. Beginning in 1990, property tax statements will show year-to-year comparative tax information for each local government.

The Commission on Intergovernmental Finance is charged with recommending better standard accounting practices and uniform reporting of budget and tax data by local units of government. It is directed to commission a study of local government service workloads and aid needs. This study may lead to later refinements of the city LGA formula's "need" factor.

Financing the plan

One of the main goals of the governor's plan is to encourage spending restraint at both the state and local levels. The raising of new taxes is not an option for funding the plan. However, without the plan's reforms, we would soon be faced with increasingly severe pressures to make major increases in property and other taxes.

Funding local aids reform

The $630 million in local aids restructuring provided for 1990 will be financed from $623 million in reductions of other existing state aids and $7 million from the state's general fund. (The county share of "transition aid" will be the principal source.) The same financing method will be used for the human services and courts restructuring scheduled in Stage Two for fiscal 1991-94. These changes require no additional taxes and will, as noted above, help to restrain future spending growth.

Costs of property tax reform

The projected increased costs for property tax reform through the next biennium are as follows:

- $274 million for taxes payable in 1990
- an additional $105 million for taxes payable in 1991 and 1992 (state fiscal years 1992-93)

Best available estimates are that the increased cost of the plan's property tax reductions for 1994 to 1999 will average $350 million per year. In comparison, the amount for similar tax rate changes in 1990 will be approximately $300 million.

Future reform and tax relief

The costs of reform through fiscal 1993 will be financed from other statewide taxes (the income tax, sales tax, etc.). Normal growth in those taxes, at their current rates, is projected to be large enough to cover the $274 million for this biennium and the $105 million increase for the next biennium, and still cover reasonable levels of spending growth for other programs.

The plan deliberately does not provide a guaranteed source of funding for the future property tax relief and local aids reform. In part, this is to encourage the spending restraint at the state and local levels contemplated by the plan.

Guaranteed funding and rapid rate reduction would be possible only through one or more of large tax increases for low-taxed property, rapid aid reductions for communities with relatively low tax rates, or increases in other taxes. Each of these approaches was rejected by the governor.

The property tax reform for fiscal 1994 and beyond, along with cost increases in programs not covered in this plan (e.g., state government costs and higher education) are intended to be financed from state general fund revenues produced by the state's existing tax structure. The following four factors should contribute to the adequacy of those revenues to fund this plan.

The first factor will be the effects of the plan's sunset provisions. Over $550 million in annual state expenditures are covered in the programs and mandates scheduled for sunset between 1992 and 1994. Various of these programs, and their associated costs, will no doubt be re-enacted by the legislature in some form, but the governor insists that every effort be made to reduce unneeded costs in the future.

The second factor will be efforts of the governor to reduce costs of programs not covered in this plan. The 1989 state departments appropriations bill contains a provision initiated by the governor which seeks to reduce expenditures in six major spending areas. The governor is committed to meeting the goals of this provision.

The third factor is the expected reduction in spending growth, at both the state and local levels, prompted by the funding redirections envisioned in the plan itself. As the state assumes more of the cost of current mandates, the state's future use of mandates will likely drop. If the state has to pay for something, the state will be less likely to require it in the first place.

This same effect should help to control local spending (and thereby reduce demands for state aid to local government). City councils and county boards will be less likely to increase local spending if they know that they will have to pay for the cost from local resources.

In part, this tendency toward spending restraint will be assisted by the plan's insistence on better estimates of mandate costs before enactment. Detailed "fiscal notes" should give better projections of both state and local costs before new legislation is finally enacted. The governor has indicated his intention to veto new program mandates that do not provide adequate state funding.

The fourth factor will be growth in the Minnesota economy. Long-range revenue projections are very difficult, but it is not unreasonable to expect state general fund revenues to grow at a rate which would allow financing much of the $346 million per year needed for increased tax relief. (As a point of reference, a 5 percent growth in state nondedicated revenues above projected fiscal 1993 levels would generate about $375 million in fiscal 1994.)

Currently, Minnesota's economy looks healthy. Our $550 million budget reserve is one of the largest in the country, and recent monthly revenue collections have been above forecast. However, even a small downturn in the economy beyond what is currently forecast would quickly extinguish the reserve.

The governor and the state Departments of Finance and Revenue believe that the plan can be financed from state tax revenue growth and spending restraint as outlined above. To the extent that future economic trends suggest otherwise, the governor will be prepared to suggest further spending reductions. In any event, the governor and the departments are convinced that failure to implement the plan poses much more serious long-term risks to state and local government finance than do the cost commitments associated with implementation of the plan.

Minnesota's state-local partnership for the 90s will bring comprehensive reform to our property tax and local aids system. It is a blueprint for making the system more fair, efficient, stable, competitive, and understandable in structure and operation. Without this comprehensive reform and accompanying fiscal restraint, Minnesota is heading for a fiscal crisis.

Governor Perpich welcomes your comments on his plan, *Minnesota's state-local partnership for the 90s.* Please address your questions or comments to his office, or to the commissioners of the Departments of Finance or Revenue.