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# The Local Government Trust Fund

The local government trust fund (LGTF) is a state-administered fund dedicated to the payment of state property tax relief aids. The fund was created to stabilize property tax relief aids by isolating them from the general fund.

This information brief discusses the local government trust fund along with two closely related elements in Minnesota's system of state/local fiscal relations that were created in the 1991 legislative session: the local option sales tax, which provides some of the revenues for the fund, and the Advisory Commission on Intergovernmental Relations (ACIR), which provides a forum for representatives of both state and local government to discuss the programs constituting the fund, as well as other aspects of state/local fiscal relations.

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# The Origin of the Local Government Trust Fund

The local government trust fund, together with the local option sales tax, arose from the legislative debate over balancing the state's budget in 1991. The debate centered around the legislature's reluctance to increase state taxes without greater recognition of the degree to which state budget problems were caused by the large portion of state revenues passed through to local governments in various aid programs.

A number of options were considered, including allowing local governments to impose a general sales tax. Ultimately, this option was rejected because of the wide disparity in the distribution of the sales tax base among communities. As a compromise, the existing system of aid programs was kept in place, with its built-in equalizing components, and local governments were asked to approve a 1/2 cent sales tax increase. Counties could choose not to impose this "local option sales tax," but then local governments in those counties would be ineligible to receive state aids. In return for approving the 1/2 percent increase, local governments were assured the money would be used for property tax relief by establishing the trust fund.

# What is the local government trust fund?

The local government trust fund (LGTF) is a state-administered fund dedicated to the payment of state property tax relief aids. Its purpose is to stabilize property tax relief aids by isolating them from the other state programs paid from the general fund. Revenues accrue to the fund equal to 2% of the 6.5% general sales tax. The various aid programs and their distribution formulas are specified in law. The aid amounts are adjusted so that the total amount of aid equals the total amount of revenue in the fund.

**Revenues accrue to the fund equal to 2 percentage points of the 6.5 percent general sales tax.** Revenues began accruing to the fund on July 1, 1991. All sales subject to the general sales tax or the motor vehicle excise tax generate revenues for the trust fund. This includes sales for which the tax rate is something other than 6.5% (such as farm machinery at 2.5%); the portion accruing to the trust fund is always 2%.

**Most of the state property tax relief programs are paid from the trust fund.** The creation of the trust fund did not signify a new wave of property tax relief programs. Rather, the appropriation language for most of the state's already-existing programs were re-written so that the payments would be made from the trust fund. For the most part, these programs were not changed -- at least in the short run. However, the programs took on a new look because they were now subject to adjustment based on the amount of revenue in the trust fund: Not enough money, and aid payments would be reduced; "extra" money, and aid amounts would be increased.

**The timing of trust fund revenues versus expenditures poses some administrative problems.** Most of the state's property tax relief programs are paid out in the first half of the fiscal year, yet revenues accrue to the trust fund at a nearly constant rate throughout the fiscal year. The trust fund is required to be balanced for each biennium, but it is allowed to go into deficit during the course of the biennium as long as it is balanced at the end. Since payments must be made long before revenues are actually collected, it is important to correctly forecast the amount of revenues likely to accrue over the remainder of the fiscal year in order to know whether aid payments should be held to original levels or increased or decreased.

# Why a trust fund for property tax relief aids?

Proponents of the local government trust fund put forth two basic reasons for supporting the change to such a funding mechanism:

**The trust fund de-politicizes the decision about the proper level of funding for property tax relief aids.** How much to spend on property tax relief is determined strictly by economic factors and is not subject to determination in the cross-fire between the political parties or between branches of government. Legislators do not have to spend such a large part of each session debating how much to spend on property tax relief. When the outcome of the debate was a reduction in property tax relief, a further round of debates would ensue over how to make the cuts -- which programs, which types of governments. Under the dedicated fund approach, changes in overall aid payments in either direction (increases or decreases) are handled routinely.

**The trust fund stabilizes the level of funding for property tax relief programs.** Although the fund's revenue source may cause fluctuations, these variations will generally not be as great as when the spending level each year was determined by the political process. Stable funding can promote more efficient spending, since governments can plan more effectively.

Opponents of the trust fund, or of dedicated funds generally, cite two main arguments against the fund:

**The fund interferes with the legislature's job of balancing all of the state's spending priorities against each other in order to reach the optimal allocation of state resources.** By isolating property tax relief programs in their own fund, the legislature is constrained from adjusting those programs upward or downward to reflect new state priorities.

**By insulating programs from periodic review by the legislature and governor, dedicated funding ensures higher levels of funding than the programs deserve on their merits.** This argument against dedicated funds in general holds that by taking programs off-budget, and subjecting them to less scrutiny, spending increases are not held in check by a process that demands they demonstrate their worthiness, and instead spending simply increases naturally as the revenue source grows.

# What aid programs are paid through the trust fund?

The trust fund was created as a mechanism to finance the state's property tax relief programs. The trust fund was created to isolate the property tax relief funds from the rest of the state budget. It facilitates the restructuring of the state aids system by separating the question of how much of the state budget to devote to property tax relief from the question of how to structure the aid programs. Many options were considered for determining the actual composition of programs in the trust fund. The principal factors for determining the initial composition of the trust fund were as follows:

**The most important criterion for determining which programs would constitute the trust fund was that the total amount of spending needed to equal the total amount of anticipated revenues.** Many alternative configurations were considered, including various combinations that would set the percentage of sales tax going into the trust fund at something other than two percent.

**Aid programs to school districts should not be paid from the trust fund, for a variety of reasons.** One of the major rationales for creating the trust fund was the perception that aids to non-school local governments suffered at the expense of school district aids whenever the state budget was tight. Since having school aid payments in the same "pot" with aids to the other types of governments would clearly involve school districts in a zero-sum game with cities, counties and towns, aids to school districts are not paid from the trust fund. Thus, school districts are not involved in the adoption of the local option sales tax and play no role in the ACIR.

**Human services aid could serve as a balancing wheel for the fund.** Because the legislature and the governor had already decided how much to spend on each of the aid programs for the current biennium before the trust fund was created, it was difficult to put together a combination of programs that would add to the correct total; namely, the amount of revenues expected to accrue to the trust fund. Human services aid became the critical element because it really was not an aid payment at all, but a transfer of funds from one state agency (and budget category) to another.[1] Therefore,

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[1]Human services aid defies easy categorization among the state's aid programs. When the state agreed to take over the full cost of income maintenance programs from the counties in 1989, the dollar amount of each county's benefit was recorded. A portion of the Department of Revenue's appropriation for property tax relief programs equal to the sum of the counties' base year benefit amounts is paid to the Department of Human Services as human services aid. The Department of Human Services then reimburses counties for 100% of all income maintenance expenses.

The initial design of the trust fund called for the fund to pay only 25% of human services aid. This meant that 25% of human services aid would be paid from the LGTF to the Department of Human Services, while the other 75% would be paid from the general fund. An interpretation was reached that if a county chose not to adopt the local-option sales tax, 25% of the county's base year savings resulting from the takeover would be withheld from the county's state reimbursement for income maintenance costs. It is not hard to see why people find it hard to fit human services aid properly into the schema of state/county relations. The 25% figure was chosen only because the resultant amount ($34.6 million) caused the trust fund to balance, based upon available cost estimates.

human services aid could be split between the trust fund and the general fund in whatever fractions were necessary to balance the trust fund.

In the end, the configuration shown in Table 1 for FY '92 was chosen. The two largest programs included were non-school homestead & agricultural credit aid (HACA), and local government aid (LGA), along with its companion program, equalization aid. Disparity reduction aid to all units other than school districts was included, as were a number of smaller programs such as attached machinery aid.

**Table 1: Programs Funded Through the Local Government Trust Fund**
(all figures in $millions)

| | FY 92 (Pay 91) | FY 93 (Pay 92) | Total FY 92/93 | FY 94 (Pay 93) | FY 95 (Pay 94) | Total FY 94/95 |
|---|---|---|---|---|---|---|
| **Major Aid Programs** | | | | | | |
| Homestead & Ag Credit Aid (HACA) (non-school) | 341.0 | 367.4 | 708.4 | 420.9 | 444.1 | 865.0 |
| Local Government Aid | 285.2 | 281.9 | 567.1 | 291.2 | 291.2 | 582.4 |
| Equalization Aid | 19.5 | 19.4 | 38.9 | 20.0 | 20.0 | 40.0 |
| Disparity Reduction Aid (non-school) | 30.3 | 29.9 | 60.2 | 29.3 | 28.7 | 58.0 |
| Community Social Services Aid (CSSA) | | 51.6 | 51.6 | 53.1 | 53.1 | 106.2 |
| Criminal Justice Aid (including public defender reimbursement) | | | | 8.4 | 8.4 | 16.8 |
| **Minor Aid Programs** | | | | | | |
| Attached Machinery Aid (non-school) | 2.4 | 2.4 | 4.8 | 2.4 | 2.4 | 4.8 |
| Mobile home HACA (non-school) | | | | | 3.0 | 3.0 |
| Minor aids and credits[a] | 2.7 | 3.0 | 5.8 | 1.8 | 1.8 | 3.5 |
| **Transfers to General Fund** | | | | | | |
| Human Services Aid | 34.6 | 5.7 | 40.3 | | | |
| Interest (to General Fund) | 0 | 24.7 | 24.7 | | | |
| Court HACA transfer | 0 | 6.1 | 6.1 | | | |
| **Payments to Individuals** | | | | | | |
| Homeowners' Property Tax Refund | | | | 58.6 | 65.1 | 123.7 |
| **Trust Fund/Aid Payment Administration** | | | | | | |
| Misc. payments to state agencies[b] | 0.5 | 0.5 | 1.0 | 0.5 | 0.5 | 1.0 |
| LGTF Administration[c] | 0.7 | 1.0 | 1.7 | 0.4 | 0.4 | 0.8 |
| Intergov. Info System | 0 | 0.4 | 0.4 | 1.2 | 1.2 | 2.4 |
| **Total Spending** | **716.9** | **793.6** | **1,510.5** | **887.8** | **920.0** | **1,807.7** |
| **Total revenues** | **717.2** | **823.4** | **1,540.6** | **876.3** | **922.7** | **1,799.1** |
| **Surplus or (Deficit)** | **0.3** | **29.7** | **30.0[d]** | **(11.4)** | **2.7** | **(8.7)** |

*a* Includes non-school transition credit, non-school disparity reduction credit, non-school prior year credit adjustments (FY 93, 94, 95), supplemental homestead credit (FY '92, '93), school transition credit (FY 92, 93), school disparity reduction credit (FY 92, 93).

*b* Includes payments to state auditor, department of employee relations, department of administration, and state demographer.

*c* Includes payments to department of revenue, department of finance, and ACIR administrative expenses.

*d* The surplus of $30.0 million was distributed to counties, cities, and towns in December of 1992. These surplus distributions were over and above the program amounts shown in the table.

# Changes in Trust Fund Composition for FY '93 and Beyond

Discussions over the proper composition of the trust fund occurred over the interim between the '91 and '92 legislative sessions. The ACIR served as a forum for these discussions, both formally at ACIR meetings and informally through interactions of the staff groups working with the ACIR. Generally speaking, the following principles were agreed upon by most of those involved:

**Trust fund expenditures that were simply transfers to the general fund violated the fundamental concept of the trust fund.** Foremost among these programs was human services aid, although general fund interest payments and a transfer having to do with the state takeover of court costs also fell into this category.

**The trust fund should be more balanced in its distribution of aids to the various levels of government.** Cities received the lion's share of the aids, with counties actually receiving very little. Yet counties were given nearly equal standing with cities on the ACIR, indicating the legislature's interest in making the property tax relief system more balanced as far as units of local government are concerned.

**The trust fund would work best if as many of the state's property tax relief programs as possible were included.** Part of the rationale in creating the trust fund was to facilitate the redesign of the property tax relief system by combining all programs under one budget. Some reform ideas involved combining aspects of the existing aid programs with programs that provided direct relief to taxpayers (property tax refund and targeting). Having some of the programs inside the trust fund and some outside frustrated attempts at these reform efforts.

**A complicating factor in the deliberations over what changes (if any) to make in the '92 session was the language pertaining to growth in trust fund revenues and aid programs.** The original language described an allocation of future growth in revenues between the general fund and the aid programs in the trust fund. (The allocation to the general fund was to come about by increasing the percentage of human services aid paid by the trust fund, which is essentially a general fund transfer.) Due to disagreement over the intent of this language, the governor vetoed that part of the trust fund legislation pertaining to the allocation of trust fund revenues for FY '94 & '95. The governor's intent was to leave open the question of how the trust fund revenues were to be allocated in the next biennium; however, the effect of the veto was to provide that all trust fund revenues in FY '94 & '95 would be paid through the LGA formula.

**Because of this disagreement and the resulting veto, there was no clear definition of a baseline distribution of aids from which to evaluate proposed changes going into the 1992 session.** Clearly some changes would need to be made, because trust fund revenues were scheduled to grow at a much higher rate than the legislature was willing to permit. (Not only was there normal revenue growth, but projected growth was even higher because the first biennium of the trust fund was not really a full two year's worth of revenues due to some timing issues.)

Given the projected revenue growth for the trust fund, and some degree of consensus about appropriate changes to its original composition, the legislature made a number of changes to the trust fund for FY '93, '94 & '95. An added complication was that as part of the legislature's overall solution to a forecast budget shortfall, the sales tax was extended to local governments, providing even more revenue for the trust fund. The result was that some major changes were made to trust fund program composition in the '92 session:

**Human services aid was eliminated for FY '94 & '95.** It was reduced considerably for FY '93, with only enough remaining to balance the trust fund.

**The stake of county governments in the trust fund was increased significantly** by including community social services aid (CSSA) in the trust fund beginning with FY '93, and adding a new aid program called criminal justice aid beginning with FY '94 (see table 2).

**The homeowners portion of the property tax refund program (also known as the circuit breaker) was included in the trust fund,** beginning in FY '94. This facilitates consideration of reforms such as combining the property tax refund program with other aid programs (such as HACA), although the renters property tax refund and homeowner targeting programs were not included in the trust fund.

**Interest payments to the general fund, as well as the general fund transfer for court costs, were eliminated** beginning in FY '94.

**Miscellaneous changes were made in minor aid programs,** generally consistent with the idea of eliminating aid programs for school districts and including all programs for taxing districts other than schools. Also, the legislature approved a study and ultimate implementation of a new system for local government reporting, and paid for that effort from the trust fund.

In addition to modifying which programs were included, the legislature approved 3% increases in funding for LGA, equalization aid, and CSSA for FY '94. With the natural growth in HACA due to the growth factors in the formula and the class rate reductions already in law, the trust fund is approximately balanced for FY '94/'95, according to current estimates.

**Table 2: Breakdown of Trust Fund Aids by Type of Jurisdiction**
(all figures in $millions)

| | FY '92 (Pay '91) | FY '93* (Pay '92) | FY '94 (Pay '93) | FY '95 (Pay '94) |
|---|---|---|---|---|
| **Counties** | **23.6%** | **28.3%** | **30.9%** | **31.7%** |
| Homestead & Ag Credit Aid (HACA) | $142.8 | $144.2 | $176.7 | $191.5 |
| Community Social Services Aid (CSSA) | 0 | 51.6 | 53.1 | 53.1 |
| Disparity Reduction Aid | 14.9 | 14.7 | 14.5 | 14.2 |
| Criminal Justice Aid | 0 | 0 | 8.4 | 8.4 |
| Attached Machinery Aid | 2.4 | 2.4 | 2.4 | 2.4 |
| TOTAL | 160.1 | 212.9 | 255.1 | 269.6 |
| **Cities** | **69.7%** | **64.6%** | **62.0%** | **61.3%** |
| Homestead & Ag Credit Aid (HACA) | $155.1 | $173.2 | $189.2 | $199.4 |
| Local Government Aid (LGA) | 283.6 | 279.7 | 288.1 | 288.1 |
| Equalization Aid | 19.5 | 19.4 | 20.0 | 20.0 |
| Disparity Reduction Aid | 14.3 | 14.0 | 13.7 | 13.4 |
| TOTAL | 472.5 | 486.3 | 511.0 | 520.9 |
| **Towns** | **3.2%** | **3.5%** | **3.4%** | **3.5%** |
| Homestead & Ag Credit Aid (HACA) | $19.1 | $22.9 | $24.4 | $25.4 |
| Local Government Aid (LGA) | 1.5 | 2.2 | 3.1 | 3.1 |
| Disparity Reduction Aid | 0.8 | 0.9 | 0.9 | 0.9 |
| TOTAL | 21.5 | 26.0 | 28.4 | 29.4 |
| **Special Taxing Districts** | **3.6%** | **3.6%** | **3.7%** | **3.6%** |
| Homestead & Ag Credit Aid (HACA) | $23.9 | $27.0 | $29.9 | $30.2 |
| Disparity Reduction Aid | 0.3 | 0.3 | 0.2 | 0.2 |
| TOTAL | 24.1 | 27.2 | 30.2 | 30.4 |
| **Total aids to taxing districts** | $678.3 | $752.4 | $824.7 | $850.4 |

* Excluding aid distribution resulting from $30.0 million surplus in LGTF for FY '93.

# How is the trust fund administered?

The Department of Revenue collects sales tax revenues and apportions the revenues between the general fund and the local government trust fund. The Department of Revenue also calculates aid amounts under the formulas governing each of the aid programs in the fund. The Department of Finance manages the fund and is responsible for revenue estimates and any aid increases or decreases resulting from the revenue estimates.

**The most complex aspect of the trust fund is the provision that aid payments must be increased or decreased to insure that revenues equal expenditures.** The timeline below shows the cycle of administrative tasks associated with payment of the major aids for calendar year '94 (FY '95). A critical point in the cycle occurs in December 1993 when local governments set their levies based upon the aid amounts that have been certified and their own judgements about the likelihood that the trust fund will be able to support that level of aid over the next 18 months. Another critical point occurs in August 1994 when the finance department estimates revenue collections for the remainder of the fiscal year, knowing that the December payments will be adjusted based on the estimate. If the estimate proves to be overly optimistic, the trust fund could end up the biennium in deficit, which the general fund would be forced to cover.[2]

**Timeline for Major FY '95 (CY '94) State Aids**

| | |
|---|---|
| July 1993 | Department of Revenue certifies CY '94 aid amounts based on projected trust fund revenues for FY '95. |
| December 1993 | Local governments set property tax levies for CY '94. |
| July 1994 | FY '95 revenues begin to accrue to trust fund. First half CY '94 (FY '95) aid payments made. Aid amounts can be adjusted from certified amounts if revenue forecast has changed. (LGTF borrows from general fund to make payment.) |
| November 1994 | Finance department issues LGTF revenue forecast for FY '95. |
| December 1994 | Second half CY '94 (FY '95) aid payments made reflecting adjustments for 11/94 revenue forecast. |
| June 1995 | Final FY '95 revenues accrue to trust fund (LGTF repays loan from general fund for payments made earlier). |

[2]As a result of 1992 legislation, the timeline for the first fiscal year of each biennium (odd calendar years) is not as complicated. The law requires that in those years aids be calculated and paid out according to their statutory formulas, without regard to the adequacy of trust fund revenues. The trust fund can carry over either a surplus or a deficit to the next year. It is only in the second year of each biennium that the trust fund must be balanced.

**Method of increasing aids.** As a result of 1992 legislation, if there are surplus revenues in the trust fund, aid for the following programs will be increased in equal proportions:

- Local government aid (LGA)
- Equalization aid
- Community social services aid (CSSA)
- County criminal justice aid

**Method of decreasing aids.** If trust fund revenues are insufficient to pay aids at their certified levels, the approach used is to make aid cuts so that each governmental unit's budget is reduced by the same percentage. A unit's aid reductions may not, of course, exceed its certified aid amount. The basis for the aid reduction is the sum of the property tax levy and the major aid amounts (LGA, equalization aid, HACA, and taconite aid) for the previous year, except that county levies for social services are excluded from the calculation. Aid reductions occurring as a result of a revenue shortfall in the LGTF are <u>not</u> permanent reductions, meaning that to the extent one year's aid is based on the previous year's aid, the certified level of aid will be used in the calculation.

# The Local Option Sales Tax Partially Finances the Trust Fund

At the same time that the legislature established the local government trust fund, it established the local option sales tax. The two are very closely linked. If a county has elected to impose the local option sales tax, the local governments (and individual taxpayers) within the county are eligible to receive funds from the local government trust fund.

**The local option sales tax is a 1/2 percent tax on general sales that, when added to the state-imposed rate of 6% makes the total sales tax rate 6.5%.** Even when the state rate is something other than 6% (such as farm equipment), the local option rate is still 1/2 percent.

**The local option sales tax was imposed in each county by a vote of the county board.** The local option tax went into effect statewide on July 1, 1991, having been adopted in all counties. Had it not been adopted by the county board in any county, it could have been approved by the governing bodies of enough of the cities and towns in the county to account for a majority of the county's population.

**The local option sales tax can be rescinded in any county in three ways:**

- The county board can vote to rescind, although this action can be overturned by the governing bodies of cities and towns in the county accounting for a majority of the county's population.
- The governing bodies of the cities and towns in the county accounting for a majority of the county's population can vote to rescind the tax.
- The tax can be rescinded by majority vote of the electorate; presentation of a petition signed by ten percent of the county's voters places the question on the ballot.

Because of the relationship between the state fiscal year and the fiscal year for local governments, and because of the relationship between the state aid programs and the property tax cycle, a great deal of lead time is necessary if a county wishes to rescind the local option sales tax. A decision to rescind must be made before August 1 of any year; then, on July 1 following the August 1 decision, the tax is eliminated. This is also the date after which all aid payments from the trust fund to recipients in the county are cut off. This timing guarantees that enough time will be available for the local governments to adjust their property tax levies to take into account the loss of trust fund aids.

# The Advisory Commission on Intergovernmental Relations (ACIR)

At the same time the trust fund was created, the legislature created the Advisory Commission on Intergovernmental Relations (ACIR). The ACIR is composed of representatives from state government and local government, and is charged with making recommendations for spending monies deposited in the trust fund, along with other more general charges.

**Table 3: Composition of the Advisory Commission on Intergovernmental Relations (ACIR)**

| Member | Appointed By | Geographical Requirement | 7/1/91 - 6/30/92 | After 6/30/92 |
|---|---|---|---|---|
| Members of the House of Representatives | Speaker of the House | At least two from districts outside the metropolitan area* | 5 | 2 |
| Members of the Senate | Subcommittee on Committees of the Rules Committee | At least two from districts outside the metropolitan area* | 5 | 2 |
| City representatives | Governor | At least two from cities outside the metropolitan area | 4 | 4 |
| County representatives | Governor | At least one from a county outside the metropolitan area | 3 | 3 |
| Town representative | Governor | | 1 | 1 |
| Representatives of the executive branch | Governor | | 2 | 2 |
| **Total membership** | | | **20** | **14** |

*When the legislative membership was reduced from five members of each body to two members of each body on July 1, 1992, the geographic requirement for non-metropolitan area representation was reduced from two to one.

**The principal charge of the ACIR is to submit recommendations to the legislature for a formula or formulas to allocate the receipts of the local government trust fund.** The commission is to submit these recommendations by February 1 of each year, to be effective for aids payable in the following year. Proposed recommendations require a three-fourths majority vote within the commission in order to be forwarded to the legislature.

**The ACIR is also given a broad charge to study whatever elements of state/local intergovernmental relations it considers appropriate.** Within this broad charge the legislation suggests that the commission may want to study state imposed mandates, and/or the use of incentives or mechanisms to increase local government efficiency through cooperation or consolidation.

**As originally constituted, legislators made up half of the ACIR membership to facilitate the linkage between ACIR recommendations and legislative policy.** In order to guarantee that the ACIR function as a source of recommendations to the legislature, and not as a separate power base for local governments to demand more state aid, the commission was given disproportionate legislative membership in its first year.

**The legislation prescribed that after the first year, the membership would change to its permanent composition, with more balance between legislative and non-legislative members.** Therefore, on July 1, 1992, the legislative membership requirements were changed.