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For those passionate about the future of America's towns and neighborhoods.



A Brief History of Minnesota's System of Local Government Finance: 1960-2010

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If you were on the City Council of a suburban Minnesota city in the 1960s, you were faced with an interesting dilemma. On the one hand, your community was very likely growing. The post-WWII economic boom had been building for 15 years or more and was continuing full-force. The federal and state governments were dedicating more and more dollars to the improvement and expansion of county, state and federal highways. Whereas 15 years earlier, your community was likely nothing but farm fields, woods and open fields, you were now a rapidly growing community.

On the other hand, the growth came with significant expenses – even after accounting for federal and state aids to assist with these costs. New roads with curbs, gutters and storm sewer. New sewer and water lines. New parks and schools. New city halls and police and fire stations. Essentially, all of the infrastructure and public services that we tend to take for granted today.

Up until this point, as a city, your only significant source of revenue was the local property tax. There have been varying levels of transfers of state-collected taxes to local governments over the years, but these monies often had to be spent on specific expenditures (i.e. roads or schools) or were very limited in amount. Thus, in order to pay for the growing demand for public services and the maintenance of infrastructure, your City Council was limited to raising property tax rates.

Throughout the 1950s and especially in the 1960s, there was a growing concern among many in Minnesota that additional sources of revenue were needed for local governments if they were to keep up with their demands. The ideas floated for such additional revenues included local sales and income taxes.

The local sales and income taxes, however, were strongly opposed by several influential organizations, including the Citizen's League. The League was concerned that a patchwork of locally instituted sales and income taxes would

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create ever-widening disparities between the “have” communities (those with significant retail centers or wealthy residents) and the “have-not” communities (those without these resources). The League also expressed a more general concern that competition among local governments for tax revenues – whatever the source – would reduce inter-governmental cooperation and harm the region¹.

As the result of the efforts of the Citizen’s League and many others, the Minnesota Legislature made significant changes to the system in which local governments receive revenues. In 1967, the State instituted a statewide sales tax of 3 percent and distributed one-fourth of those revenues to school districts and cities. In 1971-72, as part of what became known as the “Minnesota Miracle”, the state made a conscious decision to provide local governments with additional revenues outside of what they generated via the local property tax².

Recognizing the concerns of the League, the Legislature prohibited local governments from imposing their own local sales and income taxes and instead created a system where the state would take a portion of its own general fund revenues and distribute these back to local governments based on a specific formula.

Originally, the formula was based solely on population and Local Government Aid (LGA) dollars were distributed only to counties, who then distributed most of those dollars to their cities based on their share of the property tax levy. Cities have always received the bulk of the LGA dollars, but counties, townships and special districts also received aid in the early years. Over time, the LGA program

¹ See “Breaking the Tyranny of the Local Property Tax,” March 20, 1969 and “New Formulas for Revenue Sharing in Minnesota,” September 1, 1970, Citizens League (Available: www.citizensleague.org/publications/reports/fiscal/)

² Most of the attention regarding the Minnesota Miracle related to its impact on school district funding, in which the state took a primary role for the first time. The legislative changes however, also created a system for supplementing the revenues of cities, and to a lesser degree, counties and townships.

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became an exclusively city aid program as the other levels of local government were either dropped completely or covered by other forms of state aid³.

Local Government Aid has remained largely unchanged since the 1970s in its basic thrust – a general aid program designed to 1) help limit property tax increases and 2) ensure every city has enough revenue to provide its citizens with basic services. The primary adjustments to the program have been in how the state measures “need” amongst its cities – with each adjustment changing the formula by which LGA is distributed among the state’s cities.

In 2008, 2009 and 2010, with the state facing large budget shortfalls, Governor Pawlenty has either made or proposed several rounds of “unallotments” that have reduced the amount of LGA that is distributed to cities. The 2008-2010 unallotments generally exempted cities under 1,000 population, which amount to over half of the cities in the state. The Governor has proposed additional unallotments for the 2010-2011 biennium that would no longer exempt these small cities.

It is informative, given the current budget shortfalls at the state level and increasing debt at the federal level, that there was a general feeling in the late 1960s that the federal government would become a major contributor to local government revenues. From a 1969 Citizen’s League report –

“Corporate and individual federal income tax receipts are increasing at a rate of \$10 billion a year simply because of growth of the economy. With the exception of the demands of the Vietnam War it appears that revenue at the federal level will far exceed the need. At the state government level it appears that generally the rate of growth in revenue from state taxes will be sufficient to meet needs, but without any likely surplus... Because of the revenue-raising capability of the federal government there is continuing

³ Presentation to the Local Government Aid Study Group of the Minnesota Legislature, October 16, 2009. Available:

<http://www.house.leg.state.mn.us/hinfo/sessiondaily.asp?yearid=2007&storyid=1943>

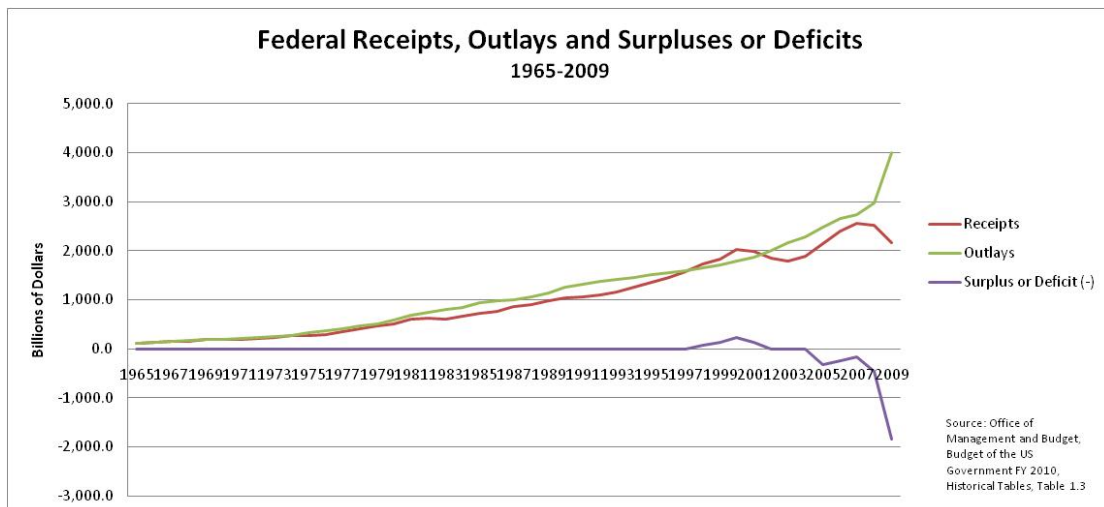
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discussion at the federal, state and local levels of direct federal revenue-sharing with the states and local governments.”

The result of the push for federal aid to local governments in the 1970s resulted primarily in a federal “General Revenue Sharing” program in 1972, which provided revenues to states and local governments with only limited restrictions on how that money could be spent⁴. The program was renewed three separate times, but eventually was ended in 1986.

Further, while the assumption that federal revenue sharing would be enacted was true (at least for a 14 year period), the expectation that federal revenues would be far in excess of need was not. While federal revenues certainly have increased since the 1970s, federal expenditures have also increased and have outstripped revenues nearly every year since 1961 with the exception of 1969 and the period between 1998 and 2001.



⁴ The program also resulted in the creation of Community Development Block Grants (CDBG) and other related grant programs which eventually spun off from these. These grants, however, were allowed to be spent only on specific projects generally aimed at economic development or housing assistance for low-income residents.

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Later, in a 1970 report, the Citizen's League noted a potential challenge associated with what they saw at the time as the trend toward revenue-raising at higher and higher levels of government:

“This trend raises some serious difficulties... particularly as it increasingly makes some public officials responsible for raising revenues they will not spend, and some others responsible for spending revenues they do not raise... we are... almost certainly in a few years – about to begin the use of the revenue-raising capacity of the federal government for the general support of the state and local units. This is an acceleration of the trend which opens up a whole new dimension of urgency and complexity in the problems of distribution.”

The importance of the disconnect between who raises revenue and who spends revenue has been a topic of debate, particularly in recent years as Governor Pawlenty and others have debated the wisdom of cuts in the LGA program.

Notably absent from the history of discussions on LGA, at least in any significant manner, is the stability of such intergovernmental transfers. While federal revenue sharing in the 1970s and early 1980s and the Minnesota LGA program were certainly designed with the intent of stabilizing local government revenue streams, it is clear that there is no such guarantee. Just as the federal revenue sharing program was subject to political and economic pressures that eventually resulted in its elimination, Minnesota's LGA program clearly is subject to the same sources of instability.

In many ways, it appears that the current debate over state aid to local governments is similar to that experienced in the late 1960s and early 1970s. Local governments are facing rising expenses while at the same time limited in their ability to generate revenue through the local property tax⁵. Discussion continues

⁵ Besides practical and political limits on the ability to raise property taxes, Minnesota counties and cities over 2,500 in population have been limited by law in their property tax increases to the lesser of inflation or 3.9 percent. Special levies for debt, public safety and certain other costs are

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over how best, or whether, to fill this gap with state aids. Other options are also being discussed, as in the late 1960s, include providing local governments with greater ability to generate revenues on their own, via sales taxes for instance⁶.

What is different now, however, appears to be a more basic question – whether state or federal government is in a position where they can even afford such aid programs themselves without a significant increase in taxes or a substantial cut in their expenditures. In the 1970s, state and federal government were looked to as having substantially more ability to generate revenue than local governments. In 2010, it seems clear that the state and federal government are likely to be significantly constrained themselves given the current political and economic climate.

not subject to the cap. See:

http://www.taxes.state.mn.us/publications/press_releases/content/PTX_levy_increase.shtml

⁶ The Association of Minnesota Counties has recently proposed that counties be allowed to implement a local sales tax. See Association of Minnesota Counties, 2009-2010 Policy Positions, Tax and Finance, p. 12. Available: www.mncounties.org. See also “Minnesota Local Sales and Use Taxes,” Report to the 2004 Minnesota Legislature, Minnesota Department of Revenue, February 2004 for a broader discussion. Available at: www.taxes.state.mn.us.