Request for City Council Committee Action from the Departments of Finance & Intergovernmental Relations

Date: March 24, 2009
To: Intergovernmental Relations Committee
Referral to: None

Subject: Report on Policy Alternatives for the State/Local Fiscal Relationship

Recommendation: Receive and file this report on policy alternatives.

Previous Directives: IGR Staff Direction #7b, Report on Staff Direction given March 3 to the IGR Committee.

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Approved by: Patrick Born, CFO and Gene Ranieri, Director of Intergovernmental Relations
Presenters in Committee: Andrew Lenz, Senior Financial Analyst, and Gene Ranieri

Reviews

None

Financial Impact

- No Financial Impact

Community Impact

- City Goals
- Program Funding

Background & Supporting Information

Recently, Finance Department staff was directed to research and report back to the Intergovernmental Relations Committee regarding the status of contributions Minneapolis provides to the State versus Local Government Aid (LGA) that Minneapolis receives from the State.

In response to this direction, Finance staff prepared a report detailing the net amount of two of the three areas where this fiscal relationship exists. These areas include the City's property tax revenue from commercial and industrial property generated within City limits that is transferred to the State, and the transfer of City sales tax revenue to the State. Information on the third type of fiscal relationship, income taxes by City, is unavailable at present.

In 2008, commercial and industrial properties within the City of Minneapolis paid approximately $74 million in property taxes to the State. While property taxes generated within the City of Minneapolis have steadily increased over the last eight years, the amount of money the City receives in the form of LGA has been declining. In constant 2010 dollars, Minneapolis will receive $100 million dollars less under the Governor's proposed budget in 2010 than what the City received in 2002. Under the Governor's proposed budget, 2010 LGA for Minneapolis is less than $54 million. These continued cuts threaten the level of services that the City will be able to provide in the future.

Finance staff also examined sales taxes generated within the City. These revenues have also experienced growth over the last several years. However, the proportion of revenue from the sales tax generated within Minneapolis that the City actually keeps is approximately 12%. From 2003 to 2007, the annual amount of the transfer to the State from sales tax collected within the City has grown from $378 million to $421 million.

Information on income tax is unavailable at present. To more closely align Minneapolis contributions to the State with aid levels received from the State, Finance Department staff identified the following policy alternatives which could be implemented.

Policy Alternatives

1) Work within the current LGA framework. Over the last 25 years, the State has reconfigured the LGA formula more than once, most significantly in 2003. By 2010, a legislative commission is to report on recommendations for changes to the formula. The City should actively work with the Legislature and the Commission to implement the following changes to the LGA program.

    a. Identify a consistent funding source for LGA and build up the State's annual contribution to the program. Since LGA has had a declining level of funding, the State could dedicate a revenue stream and set aside proceeds as designated for LGA funding outside of the State's general fund.

    b. Change the equation that LGA is based upon to a simplified one that more accurately accounts for the additional demands placed upon regional centers and central cities. Factors in the calculation could include employment base, age of residents, crime rate, or even "special needs," such as a high ratio of commercial property to total taxable property.

    Advantages:

    i. Stabilized or increased general fund revenue for the City from LGA.

    ii. Recognition of costs borne by central cities to maintain aging and heavily-used regional center infrastructure, which is heavily used by non-residents.

    Disadvantages:

    iii. Each City will want to restructure the program to account for its own interests, which could negatively impact Minneapolis.

    iv. The size of the total allocation for LGA is declining and the State's revenue picture is uncertain.

2) Develop a program to supplement LGA.

a. A program supplemental to LGA that accounts for the additional demands placed on regional centers and central cities could be implemented. Such a program could be used to offset declining LGA dollars.

Advantages:

i. Increased general fund revenue.

ii. Recognition of costs borne by central cities and regional centers to maintain aging and heavily-used regional center infrastructure, which is heavily used by non-residents.

Disadvantages:

iii. Because the program does not exist yet, there is a great deal of uncertainty as to how the program would be structured and which cities the program would benefit.

b. Another option for a new program is one structured around providing additional funding for cities with facilities and services that benefit the state as a whole (*e.g.,* Target Center or Minneapolis Convention Center).

Advantages:

i. Increased general fund revenue.

ii. Provides more equitable funding for facilities and programs that are used by people from throughout the state as well as non-residents. A formula using this basis could significantly benefit Minneapolis since the City has several such facilities and programs.

iii. May be more viable as many cities throughout the state with such facilities could potentially benefit from such a program.

Disadvantages:

iv. Funding tied to facilities and services would be formula driven, potentially making year-over-year funding erratic due to new facilities constantly being built throughout the state (college facilities, convention center expansions, etc.).

v. Because the program doesn't exist yet, there is a great deal of uncertainty as to how the program would be structured and which cities the program would benefit.

3) Completely re-imagine the State/Local fiscal relationship. (Long-term)

a. Restructure of the current State/Local fiscal relationship with a transfer of funds based on other factors, such as property tax relief tied to income levels, or to fund previously-incurred expenditures with dedicated property tax revenue, such as pensions or public facilities.

Advantages:

i. Many alternative local funding mechanisms from the State could better target resources to needs.

Disadvantages:

ii. In a restructuring of the current State/Local fiscal relationship, the City may not fare any better than it does now, and could potentially fare worse.

iii. Categorical aid to cities with previously-incurred expenditures may be difficult at the State in a time of fiscal crisis.

4) Revenue Sharing

a. A portion of the State revenue collected in a City would be returned to the City. The returned revenue could be used for general fund purposes. An example of this is a notion that a city could receive an increased share of existing local taxes. The proceeds could be used to offset general State aids and to mitigate the property tax burden for such expenses as long-term capital debt, pension costs and infrastructure improvements.

There would be an impact on the State budget, but the impact would be less the offset of aids. In other words, the proceeds of the restructured sales tax would not equal a significant State revenue decrease.

Advantages:

i. Cities would have less reliance on the State if the dedicated revenue stream was from taxes generated within the City.

ii. Increased funding stability as cities would be better insulated from State budget shortfalls.

iii. No increase to existing taxes.

iv. Some of the proceeds would come from non-residents.

v. Increased flexibility.

Disadvantages:

vi. Stability not certain.

vii. Requires State approval.

viii. May further erode equalization among cities.

5) Other Ideas.

a. A local-option sales tax (an increase to the local sales tax). The tax could either be for a specific purpose, such as public safety, or for the general fund as a whole.

If the tax was specifically dedicated to a particular purpose, such as public safety, it could provide an ongoing revenue stream to be implemented when federal programs return to normal levels after the federal economic stimulus funding is exhausted.

Such a tax could also be levied for the general fund as a whole. Many other cities comparable to Minneapolis have higher sales tax rates than surrounding jurisdictions. In fact, every city in a comparison group that Minneapolis Finance used for a benchmarking study in 2006 has a higher sales tax rate than their respective suburbs. These cities include Denver, Seattle, Salt Lake City, Kansas City, St. Louis, Houston, Dallas, and Chicago. Salt Lake City had the smallest difference in its sales tax rate compared to surrounding jurisdictions (0.85%), while Kansas City had the largest difference in sales tax rate (2.58%). The total sales and use tax rates in the aforementioned cities range from 6.4% to 9%, with an average rate difference of 1.4% over each city's surrounding suburbs. Research conducted for Minneapolis by a consulting firm indicated that consumers begin to notice a disparity in sales tax rates between jurisdictions when it exceeds 1%, and a tax difference of less than 1% would have virtually no impact on the location of retail purchases by residents and non-residents alike. Information on how Minneapolis compares to selected surrounding jurisdictions appears in the table below:

City	City Sales Tax	County Sales Tax	Total Local Sales Tax
Minneapolis	0.50%	0.15%	0.65%
St. Paul	0.50%	0.00%	0.50%
Columbia Heights	0.00%	0.00%	0.00%
Golden Valley	0.00%	0.15%	0.15%
Richfield	0.00%	0.15%	0.15%

Note: This table is not inclusive of special taxes (lodging, entertainment, liquor, etc.).

A city must get special legislation authorizing the imposition of a sales tax. Minnesota statute requires that the City Council pass a resolution indicating its desire to impose the tax prior to requesting the enabling legislation. The resolution must include information on the proposed tax rate, the amount of revenue to be raised and its intended use, as well as the anticipated date of when the tax will expire.

In 1999, the Legislature began requiring a political subdivision to hold a local referendum at a general election before imposing an authorized local sales tax. The 1999 legislation also requires that the revenue from such taxes may only be used to fund specific capital improvements, which must be identified at least 90 days before the referendum. This codified existing practice, since most special legislation authorizing local taxes passed in recent years already imposed this requirement. However, Minneapolis or other cities may request a waiver from this requirement. Such a waiver may allow for use of sales tax revenue to be applied to the general fund.

In Minnesota, Duluth is the only city with a sales tax that is not specifically dedicated to particular capital projects or uses, with the proceeds directed to the City's general fund. The Duluth 1% local sales tax has no expiration date.

Advantages:

i. Provides an ongoing revenue stream after one-time federal grant resources expire.

ii. Local voter approval of a sales tax provides leverage for legislative approval. Local approval may or may not be tied to a dedicated purpose, such as public safety.

iii. Much of the proceeds would come from non-residents who use City services.

Disadvantages:

iv. May require a campaign for voter approval.

v. Requires a waiver from current State laws requiring local-option sales taxes to be dedicated to specific capital projects, and any hold on new local taxes.

vi. Sales tax is regressive, meaning that it impacts lower-income people disproportionately. This is due to the fact that lower-income people spend a greater share of their income on taxable goods.

vii. Decreased business competitiveness with businesses in the suburbs due to a higher tax rate.

viii. If the tax was dedicated to a specific purpose, it would limit the flexibility with which proceeds from the tax could be applied, and may act as a disincentive to increase efficiencies in the dedicated area(s).

ix. Volatility could also be an issue due to the nature of the economic environment. Because sales tax collections are based on consumer and business spending, revenues generated by such a tax would not be as stable as the property tax levy.

b. Expand the use of Minneapolis Convention Center sales taxes to fund general fund activities. This option is one that could provide greater flexibility in the City's budget to react to sudden drop-offs in other revenue streams for the general fund.

Advantages:

i. Greater flexibility in the general fund.

Disadvantages:

ii. Less funding for capital costs related to the convention center.

iii. Requires State law change.

iv. Results in tradeoffs between capital priorities and general fund priorities.

v. Sustainability over time is an issue because drawing from the proceeds of the Convention Center sales tax would further draw down the fund balance of the Convention Center Fund.

c. Consider other alternatives for increasing revenue or decreasing expenditures. Options identified by City staff include the following:

i. *Higher fines for repeat offenders in problem properties.* While not a significant revenue generator, higher fines could work to mitigate problems with properties while easing the costs related to code enforcement.

ii. *Transportation utility fees.* Occasionally discussed at the Legislature, such a program's structure could vary widely and would likely be hard to implement. Revenue may also be limited to increased road or transit funding.

iii. *Street lighting fees.* All property types could be assessed for street lighting under a defined replacement schedule. The revenue could be used to make costs for street lighting closer to revenue-neutral.

iv. *Commuter taxes.* Ideas about a structure for this program are diverse and would likely be hard to implement. Revenue may also be limited to increased road or transit funding.

v. *Wheelage taxes.* A wheelage tax would be relatively easy to implement and could generate increased road or transit funding. A wheelage tax is a designated fee per-vehicle paid to the governing body that levies the tax at the time of vehicle registration. Counties that currently have such taxes are able to keep the entire amount of the proceeds. Scott, Dakota, Washington, and Anoka counties all have wheelage taxes. At the time of implementation, opposition was limited.

vi. *City income tax.* Such a program would put Minneapolis at a competitive disadvantage with surrounding communities and likely face opposition from those the program would affect. However, revenues from such a program would likely be available for the general fund. State approval and law changes would be required.

vii. *Merging Park Board services (Legal and Police) into the City.* While duplicative services would be eliminated in pursuing a merger of these services, implementation would require charter changes and agreement amongst all parties.

viii. *Merging the Crime Lab with Hennepin County's Crime Lab.* Implementation of this program would eliminate duplicative services and streamline the local investigations process. Response to Police investigations, however, would then be partially dependent on the County.

ix. *Merging 911 with Hennepin County 911.* Implementation of this program would eliminate duplicative services and streamline the local investigations process. Response to service calls, however, would then be routed through the County.

x. *"Re-imagining" Public Works service provision.* Several services provided by Public Works have been identified for outsourcing or competitive municipal bidding. If implemented however, the City may have less direct control over service levels.

xi. Service realignment. Several services provided by the City could be provided on a regional basis more efficiently. Such avenues of service provision should be explored with other service providers including municipal and county governments, as well as regional governing boards.