FREEDOM FOUNDATION OF MINNESOTA

GOVERNMENT TRANSPARENCY

SERIES

Local Government Aid

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INTRODUCTION

The Local Government Aid (LGA) program was created in 1971 as part of a major omnibus tax bill, in which the state government instituted a sales tax, significantly increased the income tax, and became the primary source of education funding. This so-called "Minnesota Miracle" also sought to reduce local property taxes and take pressure off local governments. Consequently, a significant portion of the state's newly generated tax revenue was allocated to LGA, a uniquely Minnesota form of direct aid paid to local units of government with few strings attached. Initially, counties and other local governments were included in the program, but LGA is now distributed exclusively to cities, with some cities receiving over 50% of their total revenue from LGA.

There is very little state oversight regarding cities' use of LGA funds. Many communities spend a sizable portion of their state aid not just on basic city services such as police, fire and water but also to subsidize questionable programs like municipal water parks, city-run liquor stores, and wireless Internet networks – all services best provided by businesses easily found in the Yellow Pages.

For many years, LGA has been a sacrosanct segment of the state's budget. Municipalities and their lobbying allies have fought hard to elevate LGA to an untouchable level. The mere mention of LGA cuts, even the most modest proposals, brings city leaders out to warn of devastating service cuts and public safety layoffs.

Despite the rhetoric, local governments have managed quite well at the State Capitol, even during times of economic contraction and fiscal crisis. With the notable exception of 2003, LGA has largely been spared the budget axe. In fact, even when LGA cuts were a virtual necessity to fill a short-term budget hole, it was only with the governor's unilateral "unallotment" of LGA that spending was actually cut. This unallotment did not require approval from the state legislature, which was busy debating how to hand out another $138.9 million in property tax aids for the next biennium.[1]

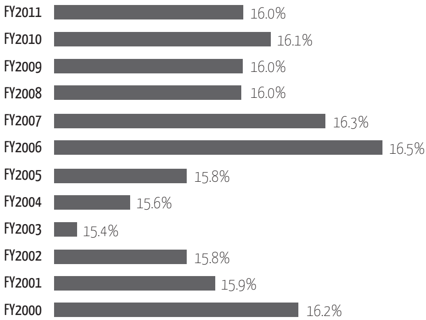
The LGA program was designed to take state tax dollars and allocate them to cities to keep property taxes under control. It is a redistributionist program that could more accurately be described as local government welfare. Perhaps the most miraculous aspect of the so-called Minnesota Miracle is that the program has not yet bankrupted the state.

UNSUSTAINABLE TAX AND SPENDING GROWTH

In the past 20 years, the State of Minnesota's general fund budget has tripled from $11.5 billion in FY 1988-1989 to $34.6 billion in FY 2008-2009. LGA now accounts for approximately $1 billion in spending each biennial budget.

Despite this staggering growth, many local government leaders and state legislators still maintain that Minnesota governments have a "revenue problem," rather than admit that we simply spend too much.

Figure 1
State and Local Revenues as Percentage of Personal Income



Data Source: Minnesota Management & Budget

As Figure 1 illustrates, state and local governments do not have a shortage of revenue, as combined revenues have consistently hovered near 16 percent of personal income. Furthermore, between 2003 and 2008, property tax revenue collected by local governments in Minnesota increased 42.5 percent, with average annual increases of $258 million. And while property taxes are the most prominent (and often maligned) generator of local tax revenue, there are many other sources of revenue for local governments. Not surprisingly, those tax collections are increasing sharply as well.

EARLY REFORMS

The LGA distribution formula has undergone significant changes in the past 38 years. Initially, the formula relied heavily upon city spending figures, which were used as a "proxy for need."[2] In other words, the more a city spent, the more they needed. Making matters worse was a "grandfather" provision, which stated that a city's aid would increase as need increased, but could not be decreased for any reason. Essentially, LGA was a one-way street to fiscal ruin for the state budget. Although LGA was eventually reformed to allow for some aid decreases, the prevalence of grandfathered aid lasted well into the new millennium. In addition to grandfathered aid, cities also benefited for many years from built-in inflationary increases.

LGA payments to special tax districts were eliminated in 1979, county payments were eliminated in 1991, and payments to towns ended in 2002. Consequently, beginning in 2002, the local government aid program became a de facto "city government aid" program.

2003 REFORMS

In 2003, facing a then-unprecedented state budget deficit of more than $4 billion, Governor Tim Pawlenty and the state legislature overhauled the LGA system. The most significant aspect of this bi-partisan overhaul was a shift from an arbitrary grandfathered system of distribution to a needs-based formula. According to the Minnesota House of Representatives non-partisan Research Department, about 60 percent of LGA was grandfathered to cities prior to 2003, after which the reform "eliminated virtually the entire grandfathered portion of the LGA and developed a new need based formula that now distributes 95 percent of the appropriation."[3]

The overhaul resulted in LGA reductions that were frequently called "draconian" by critics and city officials. However, the state had a massive $4.1 billion deficit for 2004-2005, and LGA was on track to cost over $1 billion during that biennium. And far from draconian, the cuts were limited to a small percentage of each city's previous general fund revenues, with no city losing more than 5.25 percent of their LGA-derived revenues. In the end, cities received $464.9 million in 2003.

In 1999, just four years before the LGA reforms, LGA payouts totaled "only" $384.1 million. In 2001, the city LGA appropriation was increased by an additional $140 million above the built-in inflationary increases, and the "grandfathered" city aid base was permanently increased for cities in outstate Minnesota with populations of 10,000+.[4]

Without LGA reform, 2003 payouts would have reached a staggering $586.8 million. In four years, LGA had increased more than $200 million, or 52.8 percent. In fact, even the decreased payout that year of $464.9 million was $50 million higher than in 2001.

THE CURRENT FORMULA

As a result of the 2003 overhaul, the LGA formula has been elevated to a new level of importance as well as a new level of scrutiny. Unfortunately, the formula is extraordinarily complicated, as it includes six weighted factors and relies upon statistical regression analysis. The factors in the formula include:

Percent of city's housing units that were constructed before 1940

Percent of population decline over previous 10 years

Number of vehicular accidents per capita

Average household size

Metro or non-metro

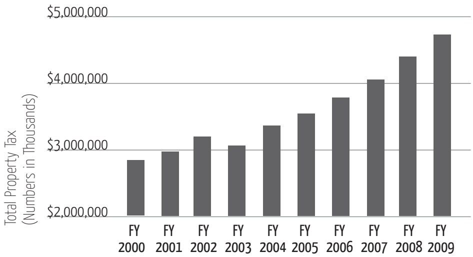
City's adjusted net tax capacity

As the list illustrates, the factors in the formula are somewhat arbitrary. While the formula may be superior to grandfathered aid and built-in inflationary increases, it has done little to reign in LGA spending as a whole.

DOES LGA BUY DOWN PROPERTY TAXES?

Minnesotans have become accustomed to hearing their city leaders blame state government for their municipal budget woes. According to many local government leaders, LGA cuts have essentially shifted a tax burden down to the local level, forcing local governments to increase property taxes.

Figure 2
Local Property Taxes Collections in Minnesota (FY2000-2009)

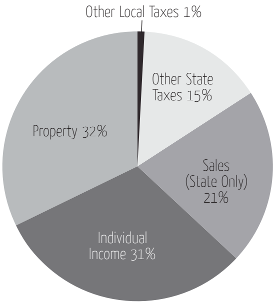


Data Source: Minnesota Management & Budget

As Figure 2 illustrates, there is no denying that local property taxes have indeed been on the rise. In this decade alone, Minnesotans have seen their property taxes increase by nearly $1.9 billion, or 67.9 percent.

In fact, property taxes comprise nearly one-third – more than any other single category – of all state and local taxes collected in the state of Minnesota.

Figure 3
Minnesota State and Local Tax Collections (FY2009)



Data Source: Minnesota Management & Budget

And while local government officials frequently complain that insufficient state aid forces them to raise property taxes, which is considered a regressive tax (i.e. an individual's tax burden is not directly tied to that individual's ability to pay), Minnesota already has a state property tax refund program for low-income and elderly homeowners and renters, which helps address the problem[5].

LGA AS EQUALIZER

How important is LGA to city government? It depends on the city. Metro core cities and rural communities tend to receive a disproportionately high share of state largesse while the suburbs receive very little. In fact, 91 cities with a combined population well over a million Minnesotans currently receive none at all. Their city taxpayers pay tens of millions of dollars into the system but take home nothing. Few numbers demonstrate the fundamental problem with this form of local government welfare better than the wild disparities between cities in terms of per capita LGA receipts.

GOVERNMENT LOBBYING GOVERNMENT

Every election cycle, candidates of Minnesota's major political parties promise to fight against special interests, ignore the lobbyists at the State Capitol, and reduce the influence of money in politics and government. However, one of the most powerful lobbies at the State Capitol is, of all things, local units of government. While the questionable practice of using taxpayer money to lobby other units of government for additional taxpayer money has been criticized by limited government advocates, the practice continues unimpeded.

In 2008, the most recent year for which data is available, local governments spent $8.6 million on lobbying activities, a 10-percent increase over 2007 levels."[6] These governmental units – cities, counties, townships, school districts and special districts – employ lobbying services in two ways. Some directly employ lobbyists or hire lobbyists on a contract basis. More commonly, an entity will pay into local government associations that provide lobbying services on behalf of cities. Not surprisingly, this taxpayer-funded lobbying is often aimed at getting more state tax dollars, primarily LGA funds.

RECOMMENDATIONS

Currently, many local governments develop annual operating budgets that rely heavily on LGA, while the state addresses persistent budget deficits that require reductions or unallotment of LGA. This dynamic has made the LGA program a costly and destabilizing impediment to efficient and effective governance at both the state and local level.

At the same time, it has become evident that reforms to LGA, whether incremental or sweeping, are woefully insufficient. While proponents of LGA and other forms of local government aid may use words like "devastating" and "draconian" to describe recent LGA recalibrations, the fact is that LGA remains a billion-dollar program that exacerbates the state's budget problems and virtually all observers agree that the formula on which it is based is deeply flawed. Therefore, two complimentary reforms should be implemented in order to return fiscal control and accountability to local governments and taxpayers.

First, LGA should be phased out in a responsible manner that allows local governments to prepare for self-sufficiency while also pursuing innovative cost-sharing and service-sharing arrangements with other local governments. The program should be gradually phased out over several years and not precipitously eliminated. Some form of direct state aid should remain available to very small cities that lack the tax base to provide basic and essential services.

In conjunction with the LGA phase out, the state should rescind unnecessary mandates and restrictions that force local governments to spend while limiting their ability to tax. Most notably, the state should rescind and refrain from imposing any tax levy caps on municipal governments, allowing cities and their taxpayers to determine the appropriate level of taxation for themselves, and eliminate so-called "maintenance of effort" requirements, which make it difficult to restrict local spending.

The phasing out of LGA and state mandates would allow each community to tax and spend according to its true needs and priorities, while giving taxpayers more influence over which programs are funded with their tax money. Ultimately, these reforms would give local governments and taxpayers greater control while providing true transparency at the local level.

ENDNOTES

1 Minnesota Management & Budget Department. “2008 Session Highlights.” http://www.mmb.state.mn.us/doc/budget/08/highlights08.pdf

2 Minnesota House of Representatives, Research Department. “City Local Government Aid Program (LGA).”

3 http://www.house.leg.state.mn.us/hrd/issinfo/lga48memo.pdf

4 Minnesota House of Representatives, House Research Department. “The History of the City Local Government Aid (LGA) Program.” http://www.house.leg.state.mn.us/hrd/issinfo/histlga.htm#A6

5 Minnesota Department of Finance. “An Overview of State Government Spending.” http://www.mmb.state.mn.us/doc/budget/op09/overview.pdf

6 Minnesota Office of the State Auditor. “2008 Local Government Lobbying Services,” http://www.osa.state.mn.us/reports/gid/2008/lobby/lobby_08_report.pdf

7 http://www.house.leg.state.mn.us/hrd/issinfo/2009proptaxbriefing_files/frame.htm

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ABOUT THE FREEDOM FOUNDATION

The Freedom Foundation of Minnesota is an independent, non-profit educational and research organization that develops and actively advocates the principles of individual freedom, personal responsibility, economic freedom, and limited government.

By focusing on some of the most difficult public policy issues facing Minnesota, we seek to foster greater understanding of the principles of a free society among leaders in government, the media, and the citizenry. Founded in 2006, we hope to create a better and more vibrant future for every Minnesotan by helping shape sound public policy. For more information about the Freedom Foundation and our projects, visit us online at www.freedomfoundationofminnesota.com.

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