Dan Salomone, Deputy Commissioner, MN Dept. of Revenue

Civic Caucus, 8301 Creekside Circle #920, Bloomington, MN 55437

April 29, 2011

Present : Verne Johnson (chair), David Broden, Paul Gilje, Sallie Kemper, Ted Kolderie, Dan Loritz, Tim McDonald, Clarence Schallbetter

Summary of meeting : Dan Salomone, Minnesota deputy commissioner of revenue, discusses whether state aid to cities should be continued; whether the aid should relate to level of spending and property tax wealth; whether property tax relief should be accomplished by giving cities state aid or whether the state aid should be given directly to citizens based on income; whether local non-property taxes should be allowed; whether state aid should be limited to certain functions, and whether aid should be contingent on a city's achieving state-prescribed results.

A. Welcome and introductions - Dan Salomone is former Commissioner of the Minnesota Department of Revenue. He was appointed commissioner in 2003, and has stayed over for a brief time from Governor Pawlenty's administration to accommodate the transition of Governor Dayton. He is currently Deputy Commissioner of Revenue.

Salomone served as Executive Director of the Minnesota Taxpayers Association from 1991-2003, has worked in several other positions in state government, and has taught at the university level throughout his career. He earned Bachelor's and Master's degrees in economics from the University of Wisconsin-Milwaukee.

B. Comments and discussion - "I want to thank you for inviting me to visit with you," the commissioner opened his remarks. "I have looked forward to this opportunity to re-examine the relationship between the state and its cities and townships. I have written a lot over the years about the state and local government relationship-and not all of it has been terribly complimentary." It's obvious that Minnesota has experienced fiscal difficulties in recent years, he said, and will continue to face challenges. But big challenges often provide political cover for big reforms.

Local Government Aid (LGA) was instituted in a different state financial context

Taking a long look back at the state and local relationship, Salomone recalled Governor Wendell Anderson's 'Minnesota Miracle. "Those were good years, financially" he said. Responding to political pressures to reduce property taxes, Governor Anderson came up with a bold proposal to raise almost every state tax, and to use the resulting new revenue to buy down property taxes. It was truly a sea change to the state and local government relationship.

With the enactment of the Minnesota Miracle, state tax revenues were substituted for local property tax revenues. Several years after the Miracle's launch, the economy plummeted and Minnesota began to get into trouble with its relatively new commitment to local governments. "Now, with the benefit 20/20 hindsight", Salomone said, we should have had more discussion about whether the structure of this bold tax plan was durable, or would need regular periodic revisions."

LGA has become increasingly unequal

When the Minnesota Miracle was implemented, all cities received some form of assistance, but over time some cities were benefited more from the plan while others were left out entirely.

Salomone went on to remind us of a major reform of LGA from 20 years ago-one that continues to be the basis of current city aid.

"Beginning in 1991, with the help of three academics Minnesota retooled the LGA formula. Two of the academics—professor Helen Ladd from Duke University and professor John Yinger from Syracuse University had just completed a book on how to develop a thoughtful state aid formula for cities. (*see America's Ailing Cities-Fiscal Health and the Design of Urban Policy . Johns Hopkins University Press, 1989*).

A 1991 LGA working group consisting of 21 state and local non-partisan fiscal analysts exchanged "policy memos" once or twice a month with the consulting academics. The memos were necessary to adapt the so-called "Ladd" formula to Minnesota's fiscal institutions and data. The goal of the Ladd formula was to provide aid to cities, which, through no fault of their own had high expenditure needs and/or low tax bases. The Ladd formula provided city aid in direct proportion to each city's "expenditure-revenue" gap. Introducing city expenditure needs into the analysis of state aids was the principal innovation of the Ladd formula (early aid formulas focused solely on city tax bases, and as such, provided an incomplete measure of a city's need for aid).

While the Minnesota Miracle deserves credit for creating a fairer distribution of state funds for K-12 education and other local needs, it may have discouraged cities from being more thrifty or judicious in their spending, Salomone said. "I think that the Minnesota Miracle created some perverse incentives at the local level. It may have been easier for many cities to lobby the state for more aid than to engage in local government reforms. "

Should the state replace direct subsidy to cities, with aid targeted to homes?

There has never been serious consideration given to discontinuing direct aid to cities and townships, Salomone said, nor has there been serious consideration given to extending the "circuit-breaker", i.e., the income-based limit on homestead property tax increases, to all property types. If such proposals were implemented, all other things constant, the existing property tax refund program would automatically provide more generous circuit-breaker payments. The LGA program provides relief to all types of property.

Should cities expect LGA to continue to decline?

Extrapolating from recent LGA history, and the growing demands in other portions of the state budget, Salomone said communities should anticipate continued reductions in general aid to local governments.

A participant asked the commissioner whether he could envision the governor being interested in reforming LGA, or in phasing it out. Salomone said he sees the governor wanting to keep it, though a gradual phase-out may occur as a matter of necessity. There could be another dramatic drop this year, he said, and "if I were a city leader I'd be planning to see less, year after year."

"Half the cities in this state don't get any aid, and the legislators in these areas are asking not just why they don't get any, but also why they are subsidizing those that do."

Should cities be allowed to exceed levy limits by local referendum?

In the Pawlenty years, levy limits were often accompanied by a local referendum option to give communities some degree of flexibility and to clarify responsibility for local property tax increases. Surprisingly, no city or county has ever used the local referendum option.

Expanding localized non-property taxes would exacerbate disparities

Within limits, access to local non-property taxes can provide needed revenue to communities and reduce pressure for increased state aid. However, Salomone said, data show that disparities in the distribution of local sales tax bases are greater than those of the local property tax. (This is not true for local income-tax bases). Providing a general local sales tax option could result in a call for costly sales tax equalization aid. This would result in increased pressure on the state budget.

A participant asked whether local sales taxes need to be on the table as an option to help resolve the deficit: Don't we need to throw a second form of tax into the equation?

Salomone responded that the state doesn't have much history with a generalized local sales tax option. Generally, we continue to restrict local sales taxes to specific projects and time frames. Proliferation of project-based local non-property taxation may complicate any future transition to a more generalized local tax option. Almost all existing local sales taxes were adopted by local referendum. As for to throwing another tax into the equation, it might make more sense to eliminate selected sales tax expenditures, of which there are many (See our on-line list of them).

Could LGA be made more accountable by categorizing funds and measuring outcomes?

The state has not required cities to measure outcomes associated with LGA payments, Salomone said. The current LGA program provides "general aid" to cities distributed through a formula that calculates the gap between local needs and local taxing capacity. The current formula recognizes that various cities face different service costs because of differing local "environmental factors." The aid formula uses statistical techniques to identify and compensate for the costs of these local environmental factors.

Theoretically, Salomone said, LGA payments could be transformed into a menu of categorical payments, each of which is associated with specific local governmental functions and outcome measures. To do this the state would have to clearly distinguish state interests from local interests, and compensate cities accordingly.

General aids have the virtue of simplicity but lack accountability. On the other hand, categorical aids tend to be more complex, but are more accountable. With categorical aids and associated outcome measures it's easier for the state to know when it has provided sufficient support to communities.

Should the state look for alternative ways to relieve costs on small cities?

Salomone said that few public officials would advocate for a minimum population as a condition of receiving state aid because it would be too controversial. Of Minnesota's 855 cities, 630 of them have populations less than 2,500. He cast this as both a blessing and a curse. Small cities have a more intimate and accountable relationship with their taxpayers, he said, but they are denied the benefits of economies of scale in service delivery that larger cities enjoy.

Should local governments consider purchasing, but not provide, services?

Local governments should see themselves as purchasers of services on behalf of their residents, Salomone argued, rather than the deliverer of the services, though in some instances it might make sense to play both roles, particularly in the metro area. In recent years there has been a trend toward transferring responsibility for police and other emergency services to counties. However, without some incentives, citizens may be hesitant to turn over certain services to higher-level governments.

In general, he argued, market-based solutions to public policy problems can result in more cost-efficient outcomes.

Levy limits are a sign of dysfunction-and are being removed

Beginning with property taxes payable in 2012, Salomone told the group, there will be no levy limits for cities and counties. In a sense, he said, the existence of levy limits is a sign of dysfunction-it infers that local communities can't be trusted to control year-to-year increases in levies and property taxes. Strict levy limits undermine the power of local governments by denying them their most important tool-the power to tax. Absent that power, local governments, to an extent, "are reduced to social clubs, with limited ability to address local fiscal needs." If the legislature re-imposes levy limits, they should be tight and meaningful.

While there is variance in property tax rates throughout the state, by and large Minnesota's overall rate of property taxation is much below the national average, particularly for homesteads. Relative to other states, then, our property tax ranking is low.

Leadership during the interim

Can you give us your perspective, a participant asked, on the need for interim work between legislative sessions, and who should do that work?

Leadership regarding public spending comes from the public and elected officials who are in a position to lead. "It's easy for the governor to issue an executive order for a study commission that would work during the interim," he said. That's the easy part.

What about legislators setting something in motion? This is not likely. "I'd expect greater effectiveness from an executive-led effort."

Getting back to the interim, it is difficult to predict whether property tax reform will be on the interim agenda, Salomone said. Property tax reform is risky and complex, with potentially many winners and losers. Those interested in reform will have to force the discussion and commit to having interim work groups and committee hearings. For these reasons, reform plans tend to come from private interest groups, not government.

The state and local fiscal relationship should be reviewed to assure that it continues to meet the policy goals of the state and the needs of communities. Because reforming the state and local relationship generally creates winners and losers, it will take strong leadership to propose reforms and deal with their technical and political implications. If there's sufficient interest, leadership might consider this an interim priority.

It is becoming increasingly more difficult for the state to maintain the covenant it has had with property owners, Salomone continued. "There is a lot of unfinished business on state/local relationship, and the interim is a good time to reassess the relationship. But one should not minimize the difficulty of launching a large scale restructuring-this requires a lot of leadership and effort."

Even so, Salomone said he is not sure the governor will work on the state and local relationship in the coming interim, saying, "he may have other fish to fry." Perhaps there could be a process by which every other year we revisit the state and local relationship. The complexity of the issue requires more focus than is likely possible in the near term.

Use LGA to encourage use of the Joint Powers law?

We tend to think of cities cooperating with cities, and school districts with school districts, a participant commented-but there is a law in Minnesota called Joint Powers that enables any two entities of government to do together that which either of them is allowed to do separately. Would it be possible to use LGA as a lever to drive the joint powers law?

"That sounds like it has merit," Salomone said. "One approach could be to withhold the second year of funding until a locality demonstrates efficiency. Another could be to shift the LGA from lump-sum aid (property tax reduction) to categorical aids as was discussed previously."

In lieu of reducing or denying funds to small cities, Salomone suggested the state could consider re-tooling current aid formulas to create more incentives for small cities to enter into joint powers agreements for collaboration and consolidation. Some small cities have high sunk costs, which make consolidation difficult. The state should also take a close look at the boundaries of police and fire districts. Many are based on 1950's populations. However, most small cities are in rural areas where opportunities for joint powers agreements and consolidation and collaboration are rare.

C. Closing -

"You're definitely on track thinking about LGA and education," Salomone told the Civic Caucus. "Given the size of our budget deficit this session, the Governor and both bodies of the legislature will have to find a budget compromise. I'm confident they'll figure it out-they always do. Hopefully we won't be in special session this summer."