



In-Depth Policy Analysis: LGA Volatility

Legislative changes address some of the increased volatility created by the 2003 reforms
Updated June 2008

In 2003, the Legislature made several changes to the local government aid (LGA) statute that yielded a much more volatile program. This document briefly describes some of the reasons for the increased volatility. The 2005 and 2008 Legislatures enacted additional reforms to the program, some of which specifically target the volatility problems. This document is an update of one released in 2003 to explain the increased volatility of the program. Where applicable, information on the 2005 and/or 2008 changes to reduce volatility has been added *in italics*.

Volatility makes budgeting difficult

City officials have experienced more difficulty predicting their LGA amounts and have seen more volatility from year to year under the new formulae enacted in 2003. There have also been frequent changes to the estimates of the amount of LGA cities will receive in the following budget year. During legislative sessions, new LGA formula proposals yield a flurry of computer runs trying to model the impacts of the proposals on each city. New estimates are prepared throughout the year as updated data become available. LGA distributions are occasionally changed even after they are officially certified on August 1, as was the case with the LGA reductions passed in 2003.

The major causes of the increased volatility are outlined below. City officials will need to keep this increased unpredictability in mind when they consider preliminary LGA estimates during their annual budget process and in long-term budget planning. The 2008 Legislature made changes to the LGA program to reduce some of the volatility created as a result of the 2003 reforms. These changes are also described below in *italicized text*.

Causes of increased LGA volatility

1. The proportion of the distribution that is grandfathered was reduced from over 60 percent in 2002 to just over 6 percent in 2004 and further reduced to roughly 5 percent in 2009. The grandfathered portion of the distribution is fixed for each city from year to year, so the old, larger grandfather provided great stability to the program's distribution.
 - a. *The 2005 Legislature created a new small cities aid base of \$6 per capita, which added some stability for cities under 2,500. The 2008 Legislature increased that small city aid base to \$8.50 per capita but it also applied a tax base (ability to pay) test to it. In other words, a small city will no longer be guaranteed to receive at least the small city aid base.*
 - b. *The 2008 Legislature also created a new aid base for cities over 5000 based on the number of jobs per capita in the city. A city eligible for this new aid base will*

receive \$25.20 for each job per capita multiplied by the population. Like the small city aid base, this aid base is tested against a city's tax capacity.

2. The new formula for cities over 2,500 population eliminated two formula factors that usually changed very little from year to year (population and commercial/industrial market value percentage) and introduced a new factor that may change significantly from year to year (3-year average of automobile accidents per capita). The new formula also tripled the dollar significance of the 10-year population decline measure. This factor impacts only 1 in 5 cities over 2,500 population, but the increased significance can greatly impact the LGA of these cities from year to year. The updated formula for cities under 2,500 population may also have greater volatility for many small cities.¹ [For more information on how the LGA formula works, see "Local Government Aid: The Technical Details of Calculating a City's Need and "LGA 101: 2009 Distribution and Beyond"].
3. The automatic inflationary increase in the LGA appropriation was eliminated. While this doesn't directly add volatility to the distribution, it has changed how the volatility is experienced. In the past, the infusion of new money each year allowed cities with increasing need to receive more LGA without reducing aid for other cities. Many cities that were becoming less in need of aid than their peers would see smaller LGA increases from year to year rather than actual LGA decreases. With the total appropriation now fixed at \$437 million, many more cities will experience actual LGA decreases from year to year as aid is shifted to other cities judged by the formula to need more aid.
 - a. *The 2008 Legislature added \$42 million to the program for the 2009 distribution and did build in some inflationary increases for future years. The final tax bill specified that the appropriation for 2010 LGA payments would increase by 2 percent over the 2009 amount. It would then increase by 4 percent of the 2010 appropriation for 2011 payments.*
4. The caps on aid increases for the three first-class cities (Minneapolis, St. Paul, and Duluth) were eliminated. In the past, these three cities had their LGA appropriation capped well below their formula need. Their caps increased at the same rate as the total appropriation. These cities could predict that their appropriation would increase each year at the same rate as inflation. Because these three cities received more than 35 percent of the entire pool prior to the 2003 changes, the stability in their appropriation also increased the predictability of the remaining share of LGA for other cities. Removing the aid caps on these cities can create significant aid shifts to and from the other cities.
5. The 2003 reforms made the impact of switching from the small city formula to the large city formula (or vice versa) more dramatic. While this only phenomenon has only affected a few cities each year, cities that grow to over 2,500 population generally saw significant reductions in their LGA payments.
 - a. *The 2005 Legislature adopted a special five-year transition mechanism to protect cities from large LGA decreases when they eclipsed the 2,500 population threshold and came under the large city formula. This transition mechanism was first*

effective for aids distributed in 2006. In the first year of the transition, 80 percent of the city's need is based on the small-city formula and 20 percent is based on the large-city formula. In the second year, 60 percent of the city's need is based on the small-city formula and 40 percent is based on the large-city formula. In the third year, 40 percent of the city's need is based on the small-city formula and 60 percent is based on the large-city formula. In the fourth year, 20 percent of the city's need is based on the small-city formula and 80 percent is based on the large-city formula. In the fifth year, the entire city formula need is based on the large city formula. The cities of Wells, Lake Crystal, Rush City, and Cohasset are currently affected.

Other changes to address volatility in the LGA program

Maximum and minimum rules

The 2003 Legislature implemented caps and floors to ease the transition to the new LGA system for some cities. These measures defined the maximum year-to-year fluctuation in each city's aid. The 2008 Legislature modified the maximum and minimum rules for all cities when it adopted additional changes to the LGA program. The limits on LGA increases are as follows:

- For aids payable in 2009 only, a city's total aid cannot increase by more than 35 percent of its net levy for the prior year.
- For aids payable in 2010 and beyond, a city's LGA distribution cannot increase by more than 10 percent of its net levy for the prior year.

Aid minimums vary based on population.

- For aids payable in 2009 only, a small city (under 2,500 population) cannot receive less than its 2008 distribution. There is one exception to this. If a city's entire 2008 payment was small city base aid, its 2009 minimum is zero.
- For aids payable in 2010 and beyond, a small city cannot receive less than its certified aid for the prior year minus the lesser of \$10 per capita or 5 percent of its 2003 certified aid amount.
- For aids payable in 2009 and subsequent years, a large city (population 2,500 and above) cannot receive less than its certified aid for the prior year minus the lesser of \$10 per capita or 10 percent of its prior year net levy.

Further, a city cannot lose more than \$300,000 in aid in any year in which the total appropriation for that year is greater than that for the previous year. This cap does not apply if the city's net tax capacity changed due to decertification of one or more TIF districts.

Data

The 2008 Legislature took other action to reduce volatility in the LGA program. Two changes in particular will help to minimize the year-to-year fluctuation in aid amounts as a result of changes in the factor data used to measure a city's expenditure need. For aids payable in 2009, the calculations will use all of the need data from the 2008 distribution. For aids payable in 2010 and beyond, each city's final expenditure need will be a rolling two-year average.

Study Group

The 2008 Legislature also called for the formation of a study commission to examine the entire LGA program and recommend reforms by the end of 2010.

Footnotes

¹The small city formula factors did not change, but the relative importance of the factors in determining aid was adjusted. Modest changes in population and commercial/industrial percentage will have a larger impact on cities' aid under the updated formula than they would have under the old formula. Countering these effects are a reduction in the importance of the 10-year population decline percentage and an increase in the importance of the percentage of housing built before 1940 (which will not change for any city until the next decennial census). Whether the updated formula is more volatile overall depends on the particular mix of formula factors in each individual city.