
LEAGUE OF MINNESOTA CITIES

# State of the Cities REPORT

2004

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**Acknowledgments**

**Researched and written by:**
Eric Willette, Policy Research Manager
Rachel Walker, Policy Research Assistant

**Edited by:**
Erica Norris, Publications Manager

**Designed by:**
Laura Zenz, Graphic Designer

**The authors would like to thank the following people who assisted in preparing this report:**
Dick Gebhart, Minnesota Department of Revenue
Doug DeGrote, Minnesota Department of Revenue
Erica Groshen, Federal Reserve Bank of New York
Chris Hoene, National League of Cities
John Jernberg, Office of the State Auditor
Michael Pagano, University of Illinois
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Gary Carlson, Intergovernmental Relations Director, LMC
Kevin Frazell, Member Services Director, LMC
Stephanie Lake, Public Relations Coordinator, LMC
Jim Miller, Executive Director, LMC
Erin Rian, Benefits Manager, LMC

*The League of Minnesota Cities is a non-profit, membership organization dedicated to helping cities throughout Minnesota build quality communities by providing effective advocacy, expert analysis, trusted guidance, and collective action. The League serves its members through advocacy, education and training, policy development, risk management, and other services.*

**League of Minnesota Cities**
145 University Avenue West
St. Paul, MN 55103-2044
(651) 281-1200 • (800) 925-1122
TDD (651) 281-1290 • Fax (651) 281-1299
www.lmnc.org

# Executive Summary

The recent recession was considered mild because recovery of the gross domestic product began relatively quickly, but the economic downturn hit state budgets hard. Minnesota's budget deficit for fiscal year 2004 was sixth worst in the nation[i]. Minnesota cities are struggling with their most challenging fiscal conditions in decades as a result of the economic recession, deep reductions in state aid and market value homestead credit (MVHC) reimbursement, and restrictive levy limits on cities over 2,500 population. City officials are working hard to maintain the quality and affordability of city services that citizens and businesses have come to expect.

The *State of the Cities Report 2004* explores broad economic and tax trends affecting Minnesota's cities and reveals the results of a survey on city fiscal conditions. The report has two distinct purposes:

- To help readers better understand major issues facing Minnesota's cities today.
- To help city officials put their own city's circumstances in the context of the broader city community.

## Fiscal conditions

The League of Minnesota Cities surveyed its membership in order to learn more about the fiscal conditions facing communities around the state. Eighty-six percent of Minnesota cities reported that they were less able to meet their financial needs in 2003 than in 2002, and 81 percent expect to be less able to meet their financial needs in 2004 than in 2003. Most of the cities reporting "better able" were cities under 2,500 population and not covered by levy limits.

**"Minnesota cities are struggling with their most challenging fiscal conditions in decades as a result of the economic recession, deep reductions in state aid and market value homestead credit (MVHC) reimbursement, and restrictive levy limits on cities over 2,500 population."**

Cuts to state aid were the most frequently cited revenue shortfall by respondent cities. Cities in Minnesota are more dependent on state aid than average and saw more severe cuts in state aid. The state reduced aid to cities by 23 percent for 2003-2004, while, nationally, state aid to cities for 2003-2004 was cut 9.2 percent.

Cities also reported shortfalls in property tax revenues. These shortfalls may have been caused by tax base changes as a result of the 2001 tax reform, including those changes that have led to ongoing shortfalls in tax increment financing (TIF) revenues or by tax delinquencies, which are more common during a recession. Cities that saw cuts to MVHC reimbursement may have reported them as a property tax shortfall.

The survey results showed that shortfalls in fees and charges, sales tax, and lodging and other tourist-related taxes also affected Minnesota cities. These shortfalls were not reported as frequently by Minnesota cities as by cities in other states (see Table ES-A). Non-Minnesota cities rely more heavily on these sources, which are much more susceptible to economic downturns than property taxes.

**TABLE ES–A**

**Percent of cities with various shortfalls in 2003**

| Shortfalls | All MN cities | Large MN cities | Large U.S. cities |
|---|---|---|---|
| State revenues | 82.1% | 96.7 | 41.5 |
| Property taxes | 28.2 | 31.1 | 11.0 |
| Fees, charges, license revenues | 17.1 | 16.4 | 21.3 |
| Lodging, restaurant, other tourist-related taxes | 4.8 | 11.5 | 22.0 |
| Federal revenues | 11.8 | 9.8 | 10.7 |
| Sales tax | 2.8 | 4.9 | 32.0 |

## Budget responses

City officials have used a wide variety of strategies to balance their budgets while striving to maintain vital public services and quality of life in their communities (see Table ES-B). The survey did not ask city officials

**TABLE ES–B**

**Frequency of reported budget responses***

The 397 cities that completed the survey used a wide variety of strategies to respond to budget challenges in 2003 and 2004

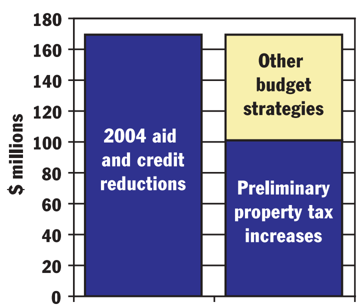
| | Implemented in 2003 | Considering for 2004 |
|---|---|---|
| Average number of strategies per city | 2.6 (of 6) | 1.9 (of 5) |
| Revenue increases | 312 cities | 327 cities |
| Spending decreases | 201 cities | 180 cities |
| Efficiency measures | 120 cities | 129 cities |
| Workforce reductions | 95 cities | 73 cities |
| Service cuts | 72 cities | 63 cities |
| Drawing down reserves 2001-2003 | 213 cities | n/a |

**The survey did not ask city officials to indicate the relative dollar impact of each strategy employed.*

to indicate the relative dollar impact of each strategy, only whether the strategy was employed. So even though more cities increased revenues than decreased spending, the dollar impact of the spending decreases may have been greater than that of revenue increases for some cities. Three hundred twelve cities (85 percent) responding to the survey increased property taxes, fees and charges, or both, in 2003. For 2004, 327 cities (93 percent) are considering these types of increases for 2004. The frequency of property tax increases was consistent across regions, population groups, and city clusters. Fee increases were most common in high-growth cities. As shown in Chart ES-A preliminary property tax increases for cities in 2004 were $101 million, while aid and credit cuts were $170 million. Cities had to employ other budget strategies to address the remaining shortfalls and any other cost increases such as new development.

**CHART ES–A**

**City budget challenge**




Two hundred one cities (55 percent) reduced spending for public safety or infrastructure spending or the overall growth rate of spending in 2003. Of the cities decreasing public safety spending in 2003, roughly 60 percent are considering additional cuts to public safety spending in 2004. Sixty-five percent of cities cutting infrastructure spending in 2003 are looking to additional cuts in infrastructure spending in 2004. Larger cities reported spending reductions more frequently than smaller cities.

City officials are implementing ways to run their cities more efficiently. Thirteen percent of cities reported increasing contracting out for services, 15 percent reported increasing productivity levels, and 18 percent reported increasing the number or scope of inter-local or other cost-sharing plans in 2003. The LMC survey asked cities to describe the cooperative efforts they engage in with other cities and with other public and private organizations. Cities identified almost 1,700 current cooperative efforts. Of the efforts for which respondents provided age information, almost half of them, 44 percent, have been in place for more than 10 years. Fifteen percent have been created in the last two years.

Cooperative efforts can save taxpayers money in a variety of ways. Cities mentioned reducing fixed costs by spreading them over more participants, avoiding major capital outlays by utilizing another jurisdiction's existing capacity, as with a water treatment plant, and gaining better negotiating power by purchasing equipment and supplies jointly. The most common

TABLE ES–C

**Cooperative efforts underway in cities**

| Service Area of Cooperative Effort | State Total (# of efforts) | Portion in Greater Minnesota Cities | Portion in Metro Cities |
|---|---|---|---|
| Police | 265 | 38% | 62% |
| Parks/Recreation | 265 | 43 | 57 |
| General government | 245 | 40 | 60 |
| Fire | 168 | 64 | 36 |
| Sanitation | 126 | 53 | 47 |
| Streets | 122 | 44 | 56 |
| Economic development | 73 | 58 | 42 |
| Other* | 418 | 39 | 61 |
| **Total Efforts** | **1,682** | **44** | **56** |

**Includes libraries, health and social programs, transit, airports, ambulance services, conservation, building inspection.*

service areas for cooperation are police, parks and recreation, and general government, e.g., joint purchasing and planning (see Table ES-C).

In 2003, 95 cities (25 percent) decreased the size of their total workforce, while 73 (20 percent) are considering reductions for 2004. Larger cities were more likely to report workforce reductions. Seventy-two cities (19 percent) reported decreasing overall service levels in 2003, while less than 5 percent reported increasing service levels. Cities also reported using reserves to address revenue shortfalls. Over the last three years, nearly 60 percent of respondents drew upon their reserves.

Aid cuts in cities that reported being less able to meet financial needs in 2003 were significantly deeper than in cities that reported being "better able." Cities that reported increasing fees, reducing public safety spending, reducing the size of the workforce, and cutting services overall had more severe aid cuts than the average city.

**"The outlook for city fiscal conditions in the next few years is largely dependent upon the strength of the economic recovery. The recovery of state and local government budgets can lag behind the overall economy."**

### Recession and recovery

The outlook for city fiscal conditions in the next few years is largely dependent upon the strength of the economic recovery. The recovery of state and local government budgets can lag behind the overall economy. The state lost 64,000 jobs between early 2001 and June 2003. Layoffs by cities and other local units of government may exacerbate the state's job outlook. The local government sector has lost about 16,000 jobs, or 4 percent, since the beginning of 2003. While most economic indicators pointed to a steady recovery by the end of 2003, job growth remains a serious concern. The current recovery deviates from historical trends in that job growth is not keeping pace with growth in the gross domestic product.

### Shift from goods to services

Even if the economy recovers quickly, trends unrelated to the business cycle are also impacting the long-term fiscal outlook of the state and Minnesota cities. The current sales tax system is capturing less economic activity due to the steady shift away from consumption of goods to consumption of services. To maintain sales tax revenues, the state and cities that impose a sales tax can either raise the rate or broaden the base to include more services. The sales tax base is also affected by the increase in remote sales, including e-commerce, for which sales tax collection is difficult. Only a handful of cities currently impose a local sales tax, but cities have long advocated for a more diverse stream of revenues than property taxes and state aid.

Resolution of these issues may be necessary for the sales tax to be a viable general revenue source for cities. For many cities with little retail activity, the sales tax would not be a useful tool. For these cities, the question remains how to diversify the ways they fund services.

### Globalization

The globalization of the economy is illustrated by the increases in jobs moving to other countries, in the choices of locations for business expansion and relocation, and in the accounting strategies used by corporations to lower their tax burden. These trends also erode government revenues. The new JOBZ program may help the approximately 280 greater Minnesota cities that were designated with tax-free zones to attract growth in an environment that is increasingly competitive based on tax policies.

### Health care costs

The rising cost of health care is putting pressure on government expenditures. This will worsen as the baby boomers age and demand health care services at higher rates. Analysis of health care expenses and premium costs suggests that premiums may rise sharply in the near future, as the growth in expenses outweighed growth in premiums during 2002. Cities are exploring changes to their health care plans, such as higher deductibles and wellness programs, in efforts to control costs.

**"The erosion of local control inhibits local elected officials from tailoring policy solutions based on the unique circumstances of their communities. State and local government officials, burdened by the fiscal challenges outlined above, have less money and time to devote to creative policy-making."**

### Aging population

The aging of the population will have serious implications on the Social Security system and government health care spending. The portion of Minnesota's population over age 65 will grow from 12 percent today to 21 percent in 2030. In addition, cities and other employers will be challenged to maintain an adequate workforce as older workers retire. Demographers forecast that while in the next few years job shortages will be the trend, a worker shortage will be the critical issue in the long-term. Overall, public sector workers are older than those in the private sector. State and local governments must consider creative policies to retain older workers, including flexible scheduling and phased-in retirement policies.

### The state of federalism

The collective decisions of policy-makers at the federal, state, and local levels on achieving public policy goals is federalism in practice. The exercise of authority by higher levels of government on lower levels and states' rights in setting policy goals are major issues in the federalism debate. Participants in a National League of Cities roundtable on federalism declared the intergovernmental partnership to be in peril. Increasing mandates and transitions to block grants are manifestations of the breakdown in communication over policy goals, needs, and capacities.

The erosion of local control inhibits local elected officials from tailoring policy solutions based on the unique circumstances of their communities. State and local government officials, burdened by the fiscal challenges outlined above, have less money and time to devote to creative policy-making. Federal and state pre-emption of city authority in areas such as business regulation, revenue raising, land use, and personnel policies also limit innovative problem-solving. Some level of uniformity and oversight by higher levels of government is appropriate. The continual loss of flexibility, however, can lead cities to abandon the creativity that has been the hallmark of local government.

**Endnotes**

[1] Measured as a percentage of the general fund. Analysis by the National Conference of State Legislatures.

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**Continued ▶**

## Table of contents, continued

# Introduction

Minnesota cities are struggling with their most challenging fiscal conditions in decades as a result of the economic recession, deep reductions in state aid and market value homestead credit reimbursement, and restrictive levy limits on cities over 2,500 population. With the gradual recovery of the state and national economies, some public officials look for state and local budgets to recover soon. But long-term economic, demographic, and public finance changes may produce budget challenges for decades to come.

The League of Minnesota Cities *State of the Cities Report 2004* explores broad trends affecting Minnesota's cities and reveals the results of a survey on city fiscal conditions. The report has two distinct purposes:
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### Chapter overview

Chapter 1 describes the results of the survey of fiscal conditions. Chapter 2 is an overview of the recent economic recession and its impact on Minnesota cities, as well as the outlook for jobs and future growth. Structural changes to the economy, including the shift from goods to services and the rising cost of health care, are the focus of Chapter 3. Chapter 4 examines the impacts that the aging of the population will have on government at all levels. The report concludes with Chapter 5 and a discussion of some of the problems of the current federalism system, including mandates, the erosion of local control, and the effects of budget deficits and pre-emption of local authority on creative policy-making. All of these trends have current and potential future impacts on the fiscal outlook of cities.

### Report methodology

The League sent each of its 820 members a survey modeled in part on the annual survey conducted by the National League of Cities. City responses were compared by region, size, and cluster. Minnesota cities were also compared to larger cities across the country using the results of NLC's 2003 Fiscal Conditions Survey.

The city cluster methodology is similar to the one used in the LMC *State of the Cities Report 2003*. Cities were classified into relatively homogeneous groups based upon population size, population change between 1990 and 2000, 2002 commercial/industrial tax base per capita, and 1999 median household income. In this year's report, however, two pairs of clusters were combined to reduce the total number of clusters from 17 to 15. This is consistent with the way state agency and legislative staff use the cluster methodology. A full description of the cluster methodology can be found on the LMC web site at: **www.lmnc.org**. Table 1D on page 7 lists the number of cities within each cluster, the dominant characteristics of each cluster, and example cities within each cluster. A list of cities by cluster is available in the appendix to this report.

### Policy issue summaries

Throughout each chapter, policy issue summaries help to clearly define the trends and identify what kinds of policies the state and cities might consider to address some of the issues. (Policy issue summaries appear in the gray boxes.)

# Chapter 1: Minnesota City Fiscal Conditions

The national economic recession, deep reductions in state aid to cities, and restrictive levy limits on cities over 2,500 population have caused Minnesota cities to grapple with their most challenging fiscal conditions in decades. Since the Minnesota Legislature finalized aid and credit cuts of $142 million for 2003 and $170 million for 2004 in late May, city officials have been struggling with difficult choices to maintain the quality of life in their communities.

The League of Minnesota Cities surveyed its 820 member cities to learn more about the fiscal conditions of cities, the causes of the fiscal problems, and the strategies being used by cities to balance their budgets and maintain services[i]. Part of the survey was modeled after an annual survey conducted by the National League of Cities to allow comparison of the fiscal condition of larger Minnesota cities to that of their national counterparts. The League also held a series of roundtable discussions on city budgets with city officials around the state during the fall 2003 LMC Regional Meetings.

**"The League of Minnesota Cities surveyed its 820 member cities to learn more about the fiscal conditions of cities, the causes of the fiscal problems, and the strategies being used by cities to balance their budgets and maintain services."**

## Tough financial times

The survey responses confirmed that these are challenging times for Minnesota cities. Eighty-six percent of cities reported that they were less able to meet their financial needs in 2003 than in 2002, while less than 12 percent reported being better able to meet financial needs (see Table 1A). Sixteen percent of cities expect conditions to improve in 2004, while 81 percent expect greater challenges in 2004 than 2003.

**TABLE 1A**

**Ability of Minnesota cities to meet financial needs**

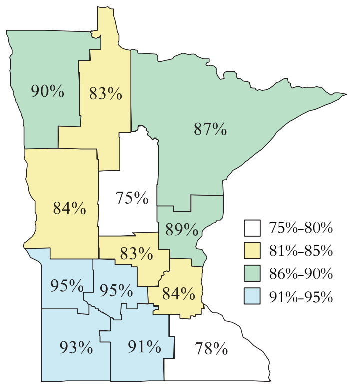
| Overall, is your city better or less able to meet financial needs … | | Better able | Less able |
|---|---|---|---|
| … in 2003 than 2002 | (number) | 46 | 332 |
| | (percent) | 11.9% | 86.0% |
| … in 2004 than 2003 | (number) | 63 | 314 |
| | (percent) | 16.3% | 81.3% |

Some of the slight improvement in outlook for 2004 may be a product of the timing of the state aid cuts. The Legislature finalized the 2003 aid cuts in late May, when cities were five months into their 2003 fiscal year. While the 2004 aid cuts will be deeper than the 2003 cuts for many cities, city officials had an opportunity to prepare their 2004 budgets with full knowledge of the depth of aid cuts and the opportunity to spread budget adjustments across a full fiscal year. In addition, cities that made permanent budget adjustments in 2003 will have those adjustments carry forward into their 2004 budgets.

Smaller cities comprised most of the "better able" responses. Thirty-seven of the 46 "better able" cities in 2003 and 51 of the 63 "better able" cities in 2004 are under 2,500 population. These cities are not covered by levy limits, and many of them had state aid cuts well below the state average.

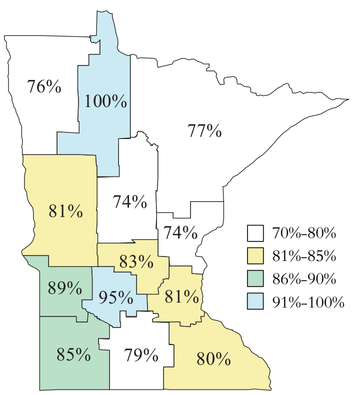
MAP 1A

**Cities less able to meet financial needs in 2003 than 2002**




MAP 1B

**Cities less able to meet financial needs in 2004 than 2003**




Geographically, the southwest corner of the state has the highest incidence of "less able" cities. No region had less than 74 percent of cities reporting deteriorating conditions in either year. Maps 1A and 1B show the percent of cities in each region that reported being "less able" to meet their financial needs in 2003 and 2004. Of the few cities that reported improved conditions for 2003, 2004 or both, more are in the north central lakes regions and the southeast.

## Causes of the budget challenges

The most often-cited cause of most cities' current budget challenges is the deep reductions in state revenues to cities that were enacted by the 2003 Legislature in response to the state's budget deficit. But other trends, both short- and long-term, are clouding the budget outlook for cities.

The recession has not just impacted state revenues to cities. In the past three years, other city revenue sources have fallen short of budgeted or expected amounts, especially property taxes, fees, charges and license revenues, federal revenues, and lodging, restaurant, and other tourist-related taxes (see Table 1B). The percent of cities reporting shortfalls was progressively higher each year in every revenue category.

TABLE 1B

**Percent of cities reporting shortfalls in revenues, 2001-2003**

| Shortfalls | 2001 | 2002 | 2003 |
|---|---|---|---|
| State revenues | 11.8% | 20.4 | 82.1 |
| Property taxes | 13.4 | 24.7 | 28.2 |
| Fees, charges, license revenues | 8.1 | 17.1 | 17.1 |
| Federal revenues | 4.3 | 5.8 | 11.8 |
| Lodging, restaurant, other tourist-related taxes | 3.0 | 4.5 | 4.8 |
| Sales tax | 0.5 | 1.5 | 2.8 |

Cities reporting property tax shortfalls may be indicating increases in property tax delinquencies, a common phenomenon during economic recessions. Some may be reporting ongoing shortfalls in tax increment financing (TIF) revenues caused by the 2001 property tax reform. Some of the shortfalls indicated for 2003 may be cities reporting reductions in market value homestead credit (MVHC) reimbursement as a property tax shortfall. The MVHC is, in effect, a portion of cities' certified levy. Although the survey instructions asked respondents to report MVHC cuts as state revenue shortfalls, some respondents may have categorized them as property tax shortfalls.

Some of the shortfalls indicated for 2002 may refer to the erosion of cities' tax bases that resulted from the 2001 tax reform law (over 20 percent for the average city). While the tax base erosion did not reduce property tax revenues directly, it did result in less property tax revenue than would have been generated at a given tax rate. Similarly, the recession has curbed the growth or even reduced commercial and industrial property market values in many cities. In aggregate, commercial and industrial market values have declined as a share of the total for cities every year since 2001, after steadily increasing from 1997 to 2001 (see Table 1C). This has caused many cities to have a smaller property tax base than they had expected in the last two years.

At any rate, it is clear city officials perceive that one of their major sources of revenue, the property tax, will be raising less revenue than they had budgeted or expected.

Cities' budget challenges are not only caused by revenue shortfalls. Spiraling health care costs and other trends within our nation's health care system impact cities directly as employers, but also indirectly through the rate of Medicaid reimbursement for city ambulance and health facilities. (These issues are described in more detail in chapters 3 and 5.)

**TABLE 1C**

**Commercial and industrial market value in cities, assessment years 1996-2003**

| | Percent of city market value that is commercial or industrial |
|---|---|
| 1996 | 19.0% |
| 1997 | 19.2% |
| 1998 | 19.6% |
| 1999 | 19.9% |
| 2000 | 20.1% |
| 2001 | 19.9% |
| 2002 | 19.1% |
| 2003 | 17.8% |

### The long-term budget outlook

Other trends will shape cities' long-term financial outlook. Structural changes to the economy are challenging the long-term soundness of state sales tax and corporate income tax policy. These changes, explored in chapter 3, may compromise the state budget for years to come, which in turn may impact state support for city-provided public services.

The aging of our population, the subject of chapter 4, may require cities to provide more services and infrastructure appropriate to older citizens. It may also require cities, like all employers, to be creative and flexible in attracting and retaining talented employees as people of traditional working age, 20 to 65, become a smaller portion of the population. The aging of our population and the commensurate change in the ratio of workers to retirees will also make it difficult for government at all levels to balance the increased demand on services with the tax burdens on workers.

These challenges are coming at a time when our intergovernmental system is suffering from deteriorating communication and coordination between the federal, state, and local levels of government in setting national policies. (The state of our federalist system is discussed in chapter 5.)

### City budget responses

In response to revenue shortfalls and other budgetary pressures, city officials have employed a wide variety of strategies to balance their budgets while maximizing the preservation of vital public services.

**"In response to revenue shortfalls and other budgetary pressures, city officials have employed a wide variety of strategies to balance their budgets while maximizing the preservation of vital public services."**

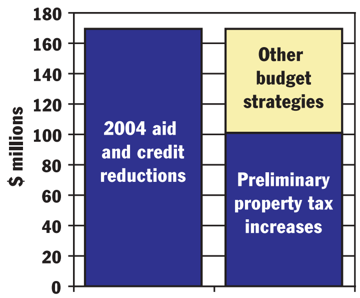
At the roundtable discussions at last fall's LMC Regional Meetings, city officials described an almost limitless range of budget actions. The variety of strategies demonstrates both the creativity of local officials and the need to tailor responses to the unique circumstances of each community.

Through its survey, the League asked member cities what actions they had taken during 2003 and what actions they were considering during 2004. The survey did not ask city officials to indicate the relative dollar impact of each strategy, only whether the strategy was employed. So even though more cities increased revenues than decreased spending, the dollar impact of the spending decreases may have been greater than that of revenue increases for some cities. For this analysis, the responses were grouped into six broad strategies:

1. *Revenue increases:* Increases in property taxes, fees, and other charges, but not increases in other revenues such as special assessments.
2. *Spending decreases:* Actual reductions in public safety spending or infrastructure spending, as well as reductions in the growth rate of operating spending. This category does not directly include reductions in other specific spending areas, so the number of cities making spending cuts of any sort could be higher.

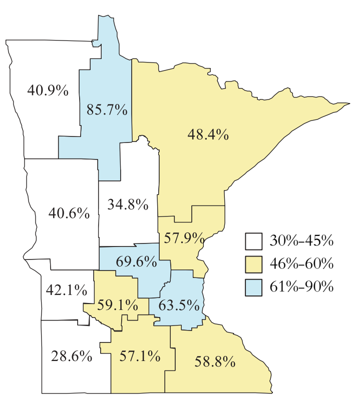
CHART 1A

City budget challenge



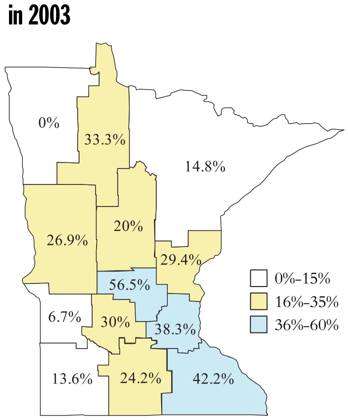

MAP 1C

Cities increasing fees in 2003




MAP 1D

Cities increasing development fees in 2003




3. *New efficiencies:* Increases in contracting out services, increasing the number or scope of inter-local cooperative agreements and other cost-sharing plans, and increasing productivity levels.
4. *Workforce reductions:* Any actions that decrease the overall size of the city workforce, including layoffs, early retirement incentives, and not filling vacancies.
5. *Service reductions:* Decreases in overall service levels to citizens[ii].
6. *Reserves:* Drawing down reserves in response to revenue shortfalls in the past three years. Cities were not asked about use of reserves in 2003 specifically or if they were considering use of reserves in 2004.

Table 1D shows the number of cities implementing or considering each of these strategies.

TABLE 1D

**Frequency of reported budget responses***

The 397 cities that completed the survey used a wide variety of strategies to respond to budget challenges in 2003 and 2004

| | Implemented in 2003 | Considering for 2004 |
|---|---|---|
| Average number of strategies per city | 2.6 (of 6) | 1.9 (of 5) |
| Revenue increases | 312 cities | 327 cities |
| Spending decreases | 201 cities | 180 cities |
| Efficiency measures | 120 cities | 129 cities |
| Workforce reductions | 95 cities | 73 cities |
| Service cuts | 72 cities | 63 cities |
| Drawing down reserves 2001-2003 | 213 cities | n/a |

**The survey did not ask city officials to indicate the relative dollar impact of each strategy employed.*

## Revenues

As shown in Chart 1A, preliminary property tax increases for cities in 2004 were $101 million, while aid and credit cuts were $170 million. Cities had to employ other budget strategies to address the remaining shortfalls and any other cost increases such as new development. To put the $101 million property tax increase in perspective, in recent years without aid cuts city property taxes increased about $70 million. Revenue increases are the most broadly-employed strategy. Three hundred twelve cities (85 percent) reported implementing increases in 2003 in property taxes, fees, and charges, or both. For 2004, 327 cities (93 percent) are considering these increases. Within this category, 61 percent of cities implemented property tax increases in 2003. The frequency of property tax increases was consistent across regions, population groups, and city clusters. (See Table 1E for a description of city clusters.)

The use of fees varies by region (see Map 1C). Fifty-two percent of cities increased fees of various kinds in 2003. Many city officials at the fall roundtable discussions reported that fee schedules were being recalculated to ensure that fee charges were covering the cost of the service provided.

Increases in fees related to new development are highly correlated with five-year population change, with increases most common in the high-growth corridor between St. Cloud and Rochester (see Map 1D). Utility franchise fees were increased in only 6.6 percent of cities in 2003, but almost 20 percent indicated they are considering increases for 2004. It is likely that the jump in cities considering franchise fee increases from 2003 to 2004 is due to the time needed to negotiate and implement franchise fee agreements.

TABLE 1E

### City clusters

City clusters organize cities into relatively homogeneous groups based on four characteristics: population in 2000, population change 1990 to 2000, median household income in 1999, and commercial/industrial tax base per capita in 2002. The analysis separated cities into the seven-county metro area and 80-county greater Minnesota. For more information, including a list of cities in each cluster, see the *Clustering Minnesota Cities* document in the Policy Research area of the LMC web site (**www.lmnc.org**).

| Cluster Name | Number of Cities | Dominant Characteristics | Example cities |
|---|---|---|---|
| ***Metropolitan Clusters*** | ***138*** | ***Cities in the seven-county Twin Cities metro area*** | |
| Central Cities | 2 | Major population and economic centers of the state and Twin Cities metropolitan area | Minneapolis and St. Paul |
| Large Cities | 12 | Large cities in the metro area besides the two central cities, with population over 45,000 | Burnsville and Plymouth |
| Old Cities | 13 | Relatively larger low-income cities with stable or declining population growth | Brooklyn Center and Richfield |
| Diversified Cities | 15 | High commercial/industrial market value per capita | Roseville and Wayzata |
| High-Growth Cities | 35 | High population growth | Chaska and Woodbury |
| High-Income Cities | 20 | Smaller cities with high median household income | Minnetonka Beach and North Oaks |
| Smaller Cities | 41 | Small population size | Hilltop and New Trier |
| ***Greater Minnesota Cities*** | ***715*** | ***Cities in the 80-county greater Minnesota area*** | |
| Major Cities | 3 | Major economic centers for greater Minnesota | Duluth, Rochester, and St. Cloud |
| Regional Centers | 22 | Large cities with high commercial/industrial market value per capita | Mankato and Marshall |
| Sub-Regional Centers | 27 | Medium-sized cities with high commercial/industrial market value per capita | Hinckley and Waite Park |
| Urban Fringe | 10 | Extremely high population growth rate and high median household income | Albertville and St. Michael |
| High-Income Cities | 26 | Very high median household income | Hanover and Oronoco |
| Moderate-Growth Cities | 59 | Higher than average median household income and higher population growth rate | Cohasset and Lake Shore |
| Established Cities | 209 | Stable or declining population, below average median household income | Moose Lake and Pipestone |
| Small Rural Cities | 359 | Population less than 500 | Bluffton and Wykoff |

Note: The *State of the Cities Report 2003* included 17 clusters. This report combines the High-Growth and Extremely High-Growth metro clusters into one High-Growth city cluster and combines the Established and Low-Income Rural clusters into one Greater Minnesota Established city cluster. This 15-cluster method is consistent with the clusters used by the League, state agencies, and the Legislature for the past year.

Fee use also varies by city type. Small and established greater Minnesota cities had incidences of fee increases well below the average. All other city clusters had higher rates of fee increases. Metro high growth, greater Minnesota high-income, and urban fringe cities reported the highest frequency of fee increases.

## Spending adjustments

Of the responding cities, 201 (55 percent) reduced public safety or infrastructure spending or the overall growth rate of spending in 2003, while 180 cities (51 percent) are considering such adjustments for 2004. The scope of the survey was limited to these types of reductions, so the totals do not represent the full extent of city service cutbacks. City officials reported many other types of spending cuts at the League's 2003 roundtable discussions, including cutting back library hours, eliminating recreation programs, canceling fireworks displays, eliminating mosquito spraying, and closing the pool or eliminating lifeguards at the beach. Given the fact that levy limits did not allow larger cities to replace 40 percent of their aid cut, spending reductions were a significant portion of the city response.

For many cities, spending reductions made in 2003 were not necessarily enough to balance the 2004 budget as well. About 60 percent of cities decreasing public safety spending in 2003 are considering additional cuts in public safety in 2004. Similarly, 65 percent of cities decreasing infrastructure spending in 2003 are considering additional infrastructure cuts in 2004.

Larger cities reported spending reductions more frequently than did smaller cities. Major cities and regional centers in greater Minnesota and the metropolitan urban core (central cities and older cities) had the highest frequency of spending cuts in 2003.

**"City officials are not only looking to revenue increases and spending cuts in response to state aid cuts and other budget pressures, they are finding smarter ways to conduct city operations."**

In contrast, many of the cities in the high-income and high-growth clusters in both the metro area and greater Minnesota reported increases in public safety (51 percent of these cities) or infrastructure spending (37 percent of these cities). Some of this difference may be explained by the fact that some high-growth cities are likely increasing spending in these areas to serve new development. In addition, because of their strong tax bases, most of the 91 cities in these clusters received little or no local government aid (LGA), so their state aid cuts were somewhat less severe than for the average city (see "Grouping cities by budget responses" section, page 11). And while levy limits are a significant constraint on many of these cities, half of the high-income cities are under 2,500 population and, therefore, not subject to levy limits.

### New efficiencies: Doing the job smarter

City officials are not only looking to revenue increases and spending cuts in response to state aid cuts and other budget pressures, they are finding smarter ways to conduct city operations. One-third of cities (120) reported increasing the efficiency of their operations in 2003 through one or more of the following:

- Contracting out services (13 percent).
- Increasing productivity levels (15 percent).
- Increasing the scope and number of cooperative agreements or other cost-sharing plans (18 percent).

Cooperative service agreements have been an important cost-saving tool for cities and other local governments for many years. Through the survey, 275 cities reported a total of 1,682 unique agreements among cities, between cities and other governments, and between cities and non-governmental organizations[iii]. Of the reported agreements whose age was identified, 44 percent have been in place for 10 years or more, while 15 percent have been created in the past two years. A higher proportion of the older agreements are for fire services, while more police and park and recreation agreements are two to 10 years old. General government agreements, including joint purchasing, planning, and administration, have become more common in the past two years.

Cost savings from cooperative agreements are hard to quantify, and the survey did not ask for estimates of dollars saved. But respondents were asked to identify which of their cooperative agreements generated the most cost savings. Respondents identified a broad array of services.

Many produced savings by reducing fixed costs by spreading them among multiple participants, as with sharing equipment, facilities or staff. Similarly, others avoided a major capital outlay by utilizing the existing capacity of another jurisdiction, as with a wastewater treatment plant. Others cited joint departments that allow a service to be provided that would be cost-prohibitive if one city did it on its own. Others reported that joint purchasing resulted in better negotiating power for insurance, equipment, and supplies.

Cities in the seven-county metropolitan area reported an average of 12.5 agreements. Regions 10 and 4 had the next highest averages at 5.7 and 5.2, respectively (see Map 1E). Averages were lowest in the northwest and south central areas of the state.

Greater Minnesota city officials cited distance between jurisdictions as one of the most frequent barriers to engaging in cooperative agreements. Map 1F shows population density by region. Maps 1E and 1F illustrate the challenge of finding economies of scale in sparsely populated parts of the state. Unfortunately, density is not an ideal measure of the distance between jurisdictions. For example, the Arrowhead region in northeast Minnesota has very low density due to large tracts of forest and wilderness areas, but some of the cities on the Iron Range or in the Duluth area are in close proximity to each other.

Cities engage in a wide variety of cooperative agreements. As Table 1F shows, the most common service areas for cooperation are police, parks and recreation, and general government. Fire, economic development, and sanitation agreements (waste hauling, recycling, water and sanitary sewer) are much more common in greater Minnesota than the metro area. For most metro area cities, the Metropolitan Council provides sanitary sewer services.

**TABLE 1F**

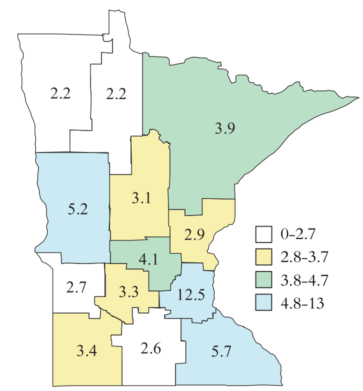
**Unique city cooperative efforts**

| Service Area of Cooperative Effort | State Total (# of efforts) | Portion in Greater Minnesota Cities | Portion in Metro Cities |
|---|---|---|---|
| Police | 265 | 38% | 62% |
| Parks/Recreation | 265 | 43 | 57 |
| General government | 245 | 40 | 60 |
| Fire | 168 | 64 | 36 |
| Sanitation | 126 | 53 | 47 |
| Streets | 122 | 44 | 56 |
| Economic development | 73 | 58 | 42 |
| Other* | 418 | 39 | 61 |
| **Total Efforts** | **1,682** | **44** | **56** |

*Includes libraries, health and social programs, transit, airports, ambulance services, conservation, building inspection.*

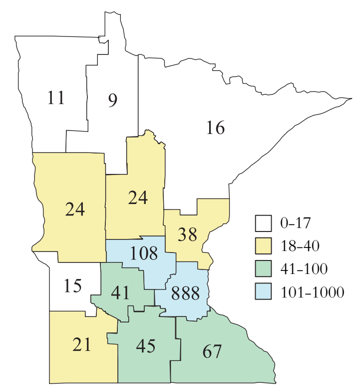
**MAP 1E**

**Average number of cooperative agreements per city**




**MAP 1F**

**Population density**
**People per square mile**



Cities that reported increasing the number or scope of cooperative agreements in 2003 reported an average of 11 existing agreements, compared to an average of six agreements for all responding cities. The difference narrows in 2004 (9 to 6), which means that while some cities that have fewer existing cooperative agreements did not establish new ones in 2003, they are considering them for 2004. This is consistent with discussions at the League's 2004 roundtables where some cities with less experience in inter-local agreements are actively exploring cooperative agreements with their neighbors, but need time to plan and implement them.

### Workforce reductions

Ninety-five cities (25 percent) decreased the size of their total workforce in 2003, while 73 cities (20 percent) are considering reductions for 2004. Workforce reductions are positively correlated with population. Larger cities may have more flexibility to make workforce changes due to their larger staffs, which yield more turnover and more opportunity for reassigning duties among remaining employees.

**"Citizens are likely to feel the impact of many of the reductions in city spending and services. However, almost 60 percent of cities that reported reductions in public safety spending or the size of their workforce in 2003 were able to do so without a corresponding decrease in overall service levels."**

Greater Minnesota regional centers, the urban core (central cities, older suburbs), and larger suburbs reported higher frequencies of workforce cuts, while high-income and small cities in greater Minnesota and the metro area, as well as urban fringe cities, reported fewer cuts and even some increases in workforce.

### Decrease in service levels

Seventy-two cities (19 percent) reported decreasing overall service levels in 2003, while less than 5 percent reported increasing service levels. City officials at the League 2003 roundtables frequently cited libraries, recreation programs, and public works as targets of cuts. Cities above 10,000 population were almost three times as likely as cities under 10,000 population to decrease service levels. As with workforce and spending reductions, a higher percentage of regional centers, cities in the urban core, and large suburbs reported decreases in overall service levels in 2003.

Citizens are likely to feel the impact of many of the reductions in city spending and services. However, almost 60 percent of cities that reported reductions in public safety spending or the size of their workforce in 2003 were able to do so without a corresponding decrease in overall service levels.

### Using reserves

Two hundred thirteen of responding cities (60 percent) reported drawing down reserves in response to shortfalls in revenues in the past three years. Drawing down reserves can be a useful budget strategy if the funds are used to cover a temporary shortfall or to fill a budget gap until more permanent, structural expenditure and revenue changes can be implemented. But using reserves to fill an ongoing budget gap is not effective because it is one-time money. Similarly, other spending reductions, such as delaying or canceling a planned capital project or purchase, also result in one-time savings rather than ongoing annual savings.

Small cities in both greater Minnesota (40 percent) and in the metro area (52 percent), as well as regional centers (40 percent), used reserves less frequently than other types of cities.

Recently, the Office of the State Auditor (OSA) reported on the decline in the reserves of cities over 2,500 population (called "unreserved fund balances" by the OSA). These cities' reserves grew as a percent of current expenditures from 47.8 percent on Dec. 31, 1998, to 54 percent at the end of 2000. They leveled off in 2001 and declined to 51.5 percent at the end of 2002[iv].

## Grouping cities by budget responses

Because of the uniqueness of each city's budget, set of services, and city council philosophy, budget strategies varied significantly between and within clusters, regions, and population groups. Still, a clear pattern emerged.

Overall, the frequency of use of budget strategies was similar among greater Minnesota major cities, regional centers, metro old cities, metro large cities, and central cities (hereafter referred to as the Broad Strategies group). A higher proportion of respondent cities in these clusters raised revenues, cut spending, and reduced workforce.

A second group of clusters with below-average frequency of these same strategies included small, high-income, and high-growth city clusters in both greater Minnesota and the metro area (Narrow Strategies group).

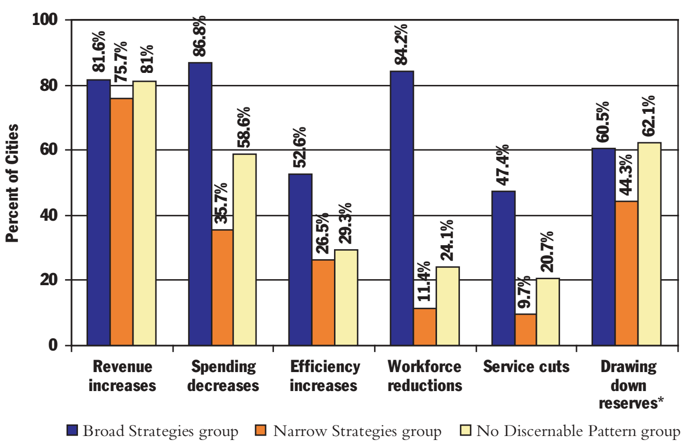
A third group of clusters, which included established cities, moderate-growth cities, and sub-regional centers in greater Minnesota and metro diversified cities, showed no discernable pattern of budget strategies (No Discernable Pattern group).

Most of the cities in the Broad Strategies group are among Minnesota's largest cities (average population of 38 responders is 49,000), while most in the Narrow Strategies group are smaller cities (average population of 185 responders is 3,500). City size likely explains much of the variation between these two groups—cities with larger staffs, larger budgets, and more services are likely to employ a more diverse group of budget strategies.

Another likely factor is that the cities in the Broad Strategies group also received, on average, deeper cuts in state aid, especially as measured on a per capita basis (see sidebar). Chart 1B compares the groups' budget strategies for 2003, while Table 1G compares the characteristics of the three groups of city clusters.

**CHART 1B**

**Frequency of reported 2003 budget strategies by city group**




**Reserves drawn down from 2001 to 2003.*

**SIDEBAR**

### Measuring aid cuts

For the purposes of analyzing choices in budget strategies, three ways to measure aid cuts were used:

1. Per capita—the amount of aid cut per resident of the city. The unweighted average of cities' aid cuts was about $28.69 per capita in 2003, and $30.18 per capita in 2004.
2. Revenue base—the cut as a percent of state aid plus property taxes. This is an approximation of the impact on a city's operating budget. The unweighted average of cities' aid cuts was about 6.8 percent of revenue base in 2003, and 7.1 percent of revenue base in 2004.
3. Tax base—the cut as a percent of net tax capacity. The unweighted average of cities' aid cuts was about 7.2 percent of tax base in 2003, and 7.5 percent of revenue base in 2004.

For any individual city, the number of budget strategies employed is not a de facto indication of the depth of aid cuts. Some cities with severe budget challenges may be employing fewer strategies to a great degree (e.g., higher property tax and fee increases but no service or workforce cuts), while others with less severe budget challenges may be employing all strategies to a modest degree.

**TABLE 1G**

**Cities grouped by budget responses (comparison of characteristics by city group)**

| | **Broad Strategies group** | **Narrow Strategies group** | **No Discernable Pattern group** |
|---|---|---|---|
| *Clusters* | *Greater Minnesota Major, Regional Centers; Metro Old, Large, and Central* | *Greater Minnesota High-Income, Small, and Urban Fringe; Metro High-Income, Small, and High-Growth* | *Greater Minnesota Established, Moderate-Growth, Sub-Regional Centers; Metro Diversified* |
| Average number of budget strategies per city implemented in 2003 | 4.1 | 2.0 | 2.8 |
| Average population of respondents | 49,210 | 3,465 | 2,808 |
| Total population in clusters (including non-respondents) | 2,298,017 | 979,494 | 769,275 |
| 2003 aid cut per capita | $35.10 | $22.29 | $34.10 |
| 2003 aid cut as a percent of levy plus state aid | 8.3% | 6.1% | 7.2% |
| 2003 aid cut as a percent of tax base (net tax capacity)[v] | 5.6% | 5.8% | 9.1% |

**"Aid cuts were much worse than the average for cities that are increasing fees, reducing public safety spending, reducing the size of their workforce, and cutting services overall."**

## Relationship of aid cuts to budget responses

Given the pattern shown in Chart 1B, the relationship of budget strategies to the depth and type of aid cuts the cities received was explored in more detail. The formula the Legislature enacted for distributing aid cuts was complicated, and explaining it is beyond the scope of this report. But one of the more significant variations among cities is that while there was a formula for the size of aid cuts, some cities were certified to receive less state aid and credit payments than the amount of aid cut the formula assigned to them. Because of this, 53 cities lost all of their state aid for 2003 and 2004, but still did not lose as much aid as other cities (by any of the three measures). Thirty-seven of these cities are in the small, high-income, and high-growth clusters included in the Narrow Strategies group.

Cities reporting that they were less able to meet financial needs in 2003 had significantly deeper aid cuts than those that reported being "better able." Aid cuts were much worse than the average for cities that are increasing fees, reducing public safety spending, reducing the size of their workforce, and cutting services overall. In contrast, the depth of aid cut did not seem to impact the likelihood of a city increasing taxes or depleting reserves over the past three years.

Cities with MVHC reimbursement cuts adopted budget strategies that were only modestly different than those of cities with only LGA cuts. Cities with MVHC cuts lost all of their LGA and some or all of their MVHC reimbursement for 2003 and 2004. This group includes those cities that lost all their aid and did not receive their full "formula" share of aid cut[vi]. MVHC cuts are scheduled to be restored in 2005, while cuts to the LGA program are not.

The two groups showed surprising similarity in budget strategies, especially for 2004. This may imply that the strict levy limits led to a similar overall budget impact. For example, of the cities with significant MVHC cuts, 18.4 percent were better able to meet their city's financial needs in 2003 than in 2002, compared to 10.8 percent of cities with LGA-only cuts. But this difference disappeared in 2004 (16.3 percent to 16.2 percent).

Some differences, however, did surface. Compared to cities receiving LGA-only cuts, fewer MVHC-cut cities decreased infrastructure spending and more increased infrastructure spending in both 2003 and 2004. Many of the MVHC-cut cities are high-growth cities that are less likely to reduce infrastructure spending overall, even if some cutbacks are made from planned amounts.

MVHC-cut cities had similar workforce reductions and increases to LGA-cut cities in 2003, but in 2004 more are considering increasing the size of their workforce. This could indicate that some MVHC-cut cities are anticipating continued population and tax base growth, the scheduled restoration of MVHC cuts in 2005, and/or the scheduled sunset of levy limits in 2005.

**"Overall, 86 percent of Minnesota cities were less able to meet their financial needs in 2003 than in 2002, compared to 81.3 percent of large cities nationally."**

### Comparing Minnesota cities to cities nationally

The survey demonstrates the challenging fiscal conditions facing Minnesota's cities. But how do Minnesota cities compare to their counterparts across the country? Part of the answer comes from a similar survey of cities over 10,000 population conducted annually by the National League of Cities[vii].

Overall, 86 percent of Minnesota cities were less able to meet their financial needs in 2003 than in 2002, compared to 81.3 percent of large cities nationally. Almost 97 percent of Minnesota cities over 10,000 population were less able to meet their financial needs in 2003. Conditions were better nationally in 2003, but more Minnesota cities expect improvement in 2004 over 2003 (see Table 1H).

Some of this difference may be a matter of timing. Shortfalls in state revenue were more common for cities in other states than in Minnesota in 2001 (19 percent nationally; 12 percent in Minnesota) and 2002 (34 percent nationally; 20 percent in Minnesota). So for some cities in other states, the worst budget times may have occurred prior to 2003.

**TABLE 1H**

**Ability of cities to meet financial needs (nationally and in Minnesota)**

| | Large U.S. cities | Large MN cities | All MN cities |
|---|---|---|---|
| Percent of cities less able to meet financial needs in 2003 than 2002 | 81.3% | 96.7 | 86.0 |
| Percent of cities less able to meet financial needs in 2004 than 2003 | 82.6 | 93.4 | 81.3 |

For 2003, however, Minnesota cities reported shortfalls in state shared revenues twice as frequently as cities nationally (see table 1I). While 24 states reported reducing aid to cities from 2003 to 2004, the average reduction was 9.2 percent of the programs cut[viii]. Cuts to Minnesota cities were much more severe—about 23 percent of the two programs that were cut (LGA and MVHC reimbursement). Minnesota cities are more dependent upon state aid than average, so the cuts had a more significant budget impact.

**TABLE 1I**

**Percent of cities reporting various shortfalls in 2003**

| Shortfalls | Large U.S. cities | Large MN cities | All MN cities |
|---|---|---|---|
| State revenues | 41.5% | 96.7 | 82.1 |
| Property taxes | 11.0 | 31.1 | 28.2 |
| Fees, charges, license revenues | 21.3 | 16.4 | 17.1 |
| Lodging, restaurant, other tourist-related taxes | 22.0 | 11.5 | 4.8 |
| Federal revenues | 10.7 | 9.8 | 11.8 |
| Sales tax | 32.0 | 4.9 | 2.8 |

**"Large Minnesota cities were much more likely to increase property taxes, increase development fees, cut public safety spending, reduce the workforce, increase cooperation, and reduce overall services than their national counterparts."**

Minnesota cities also reported much higher incidence of property tax shortfalls in 2003. As mentioned above, some of this difference may be due to reporting of ongoing shortfalls in TIF revenues caused by the 2001 property tax reform. Other cities may be reporting MVHC reimbursement cuts as a property tax, rather than as a state revenue shortfall.

In contrast, non-Minnesota cities had significantly higher rates of shortfalls in sales, lodging, restaurant, and tourism-related taxes, fees, and charges. Many non-Minnesota cities are more reliant on these revenue sources, which tend to be much more susceptible to economic downturns than the property tax, Minnesota cities' primary revenue source.

Large Minnesota cities were much more likely to increase property taxes, increase development fees, cut public safety spending, reduce the workforce, increase cooperation, and reduce overall services than their national counterparts (see Table 1J). This is likely in response to the fact that

**TABLE 1J**

**Percent of cities enacting various budget responses in 2003**

| Strategy | Large U.S. cities | Large MN cities | All MN cities |
|---|---|---|---|
| Reduce workforce | 33.7% | 67.2 | 25.5 |
| Draw down reserves (2001-2003) | 69.2 | 66.7 | 59.5 |
| Increase property taxes | 18.6 | 61.0 | 61.4 |
| Increase development fees | 27.7 | 54.2 | 29.2 |
| Decrease overall service levels | 12.7 | 41.7 | 18.9 |
| Cut public safety spending | 7.8 | 37.7 | 22.4 |
| Increase cooperation | 20.4 | 30.0 | 17.8 |
| Increase productivity | 33.6 | 21.7 | 15.3 |

Minnesota cities' state revenue shortfalls in 2003 were much more severe than in many other states.

According to the NLC survey, Minnesota's Midwestern counterparts' responses were much closer to the national averages than were those of large Minnesota cities—although their percentages fell between the two groups for state revenue shortfalls in 2003 (66.7 percent) and reductions in public safety spending (13.4 percent).

### *Policy Issues*

Most Minnesota cities reported deteriorating fiscal conditions in the past year and expect further deterioration in 2004. Cities are experiencing shortfalls in many revenue sources, most notably an average 23 percent reduction in general state shared revenue programs, and expenditure pressures such as health insurance costs and population growth. These conditions have led city officials to employ a wide variety of budget strategies including finding new efficiencies, increasing taxes and fees, cutting expenditures and services, reducing the size of the city workforce, and drawing down reserves.

As the state government grapples with additional budget shortfalls, the impacts of additional reductions in aid to cities should be carefully weighed against the impacts these actions will have on citizens' quality of life. Even if there are no more reductions in state and federal aid, other economic and demographic trends and a weakening system of federalism spell trouble for state and local budgets for the next several decades.

**Endnotes**

[i] 397 of LMC's 820 members responded, a 48.4 percent response rate. The response rate was 57.7 percent for cities over 500 population. At the time of the survey there were 33 cities in Minnesota that were not LMC members. The largest non-member city has a population of less than 200.

[ii] Service reductions are often inter-related to other budget actions. The difference between a service reduction and a productivity increase, for example, can in some cases be open to interpretation. Say a city reduces its library staff by one person during evening hours, but maintains the same hours of operation. Some may describe that as an efficiency increase, while others would categorize it as a service reduction.

[iii] Although 397 cities responded to the survey, only 286 reported cooperative agreements. In eliminating duplicate agreements, the number of cities was reduced to 275. Blank responses could have indicated either no cooperative agreements or simply non-response. City averages were calculated based only on cities with responses, so averages may be overstated.

[iv] "Revenues, Expenditures and Debt of Minnesota Cities, 2002," Office of the State Auditor, December 19, 2003.

[v] This measure is somewhat problematic because the Narrow Strategies group contains a mix of cities with some of the richest and poorest property tax bases. The Mixed Strategies group is dominated by cities with very low tax bases. As such, comparing the average cut as a percent of tax base for these groups is not very meaningful since they are impacted by both aid cut and tax base differentials.

[vi] Responding cities were divided into three categories: Those with only LGA cuts (333 cities), those with more than half of their total cut from LGA (15 cities), and those with more than half of their cut from MVHC reimbursement (49 cities). For the purposes of analyzing whether the type of cut impacted budget strategy behavior, only the groups at the two extremes were compared.

[vii] National League of Cities, "2003 Fiscal Conditions Survey." Based on 328 responses.

[viii] National League of Cities, "Is the Federal-State-Local Partnership Being Dismantled?" 2003.

# Chapter 2: The Economy — Recession and Recovery

The recent economic downturn has hit cities hard, causing shortfalls in the various revenue streams on which they depend to provide police, fire protection, and other important services to residents. Table 2A displays the results of the League's survey on what kinds of revenue shortfalls Minnesota cities have experienced between 2001 and 2003.

**TABLE 2A**

**Percent of cities reporting shortfalls in revenues, 2001-2003**

| Shortfalls | 2001 | 2002 | 2003 |
|---|---|---|---|
| State revenues | 11.8% | 20.4 | 82.1 |
| Property taxes | 13.4 | 24.7 | 28.2 |
| Fees, charges, license revenues | 8.1 | 17.1 | 17.1 |
| Federal revenues | 4.3 | 5.8 | 11.8 |
| Lodging, restaurant, other tourist-related taxes | 3.0 | 4.5 | 4.8 |
| Sales tax | 0.5 | 1.5 | 2.8 |

The most widespread shortfall for cities in Minnesota has been in cuts to local government aid (LGA) and market value homestead credit (MVHC) reimbursement that were part of the state budget-balancing package enacted in 2003. Cities have also been plagued by depressed commercial and industrial property values. This trend has led to a shifting of tax burden to residential property, which continues to show strong market value growth despite the economic slowdown.

**"The most widespread shortfall for cities in Minnesota has been in cuts to local government aid (LGA) and market value homestead credit (MVHC) reimbursement that were part of the state budget-balancing package enacted in 2003."**

The 2001 changes to the Minnesota property tax classification system and the phasing-out of the limited market value program have contributed to this shift. Although not included on the survey, several cities have communicated to the League that city investment earnings have been much lower than budgeted as a result of the decline in interest rates. Investment earnings have declined as a percent of city revenues from 7.5 percent in 2000 to 4 percent in 2002[i].

Total federal, state, and local tax receipts have fallen 10.3 as a percentage of gross domestic product (GDP) since 2000, the sharpest decline since World War II[ii]. While most indicators now point to a steady recovery for the economy as a whole, the recovery of state and local governments may lag. The creation of new jobs is slow even though the business sector is starting to show increased demand for new inventory. A slow job recovery can slow the recovery of individual income and sales tax revenues on which states heavily depend. States and cities, therefore, are still facing the threat of continuing widespread revenue shortfalls that may create further deficits, which means additional difficult budget-balancing decisions may be necessary.

## State deficits

Minnesota, like almost every other state in the country, has had to weather a fiscal crisis. Capital gains income taxes grew significantly during the technology boom and stock market rally of the late 1990s and fueled strong state budget surpluses, but have declined with the stock market downslide. Job losses have hurt state income and sales tax revenues, while spending demands for social services and Medicaid have continued to grow steadily. There has been a dramatic turnaround from the days of state tax cuts and tax rebates.

During the last legislative session, Minnesota lawmakers had to solve a $4.2 billion two-year deficit**.** Since fiscal year 2001, states have had to close budget gaps totaling approximately $200 billion[iii]. Minnesota's budget deficit was estimated as one of the most severe in the country (as can be seen in Table 2B of the most recent data on state budgets for fiscal year 2004 from the National Conference of State Legislatures).

**TABLE 2B**

**Ten largest FY 2004 state budget deficits as percentage of general fund budget***

| Rank | State | Estimated FY 2004 Budget Gap as of April 2003 ($ Millions) | Gap as Percent of General Fund Budget |
|---|---|---|---|
| 1 | Alaska | $600 | 25.0% |
| 2 | Arizona | $1,500 | 25.0 |
| 3 | New York | $9,300 | 24.0 |
| 4 | California | $17,500 | 20.6 |
| 5 | Oregon | $850 | 17.0 |
| 6 | Minnesota | $2,376 | 15.5 |
| 7 | Colorado | $869 | 15.0 |
| 8 | North Carolina | $2,000 | 14.0 |
| 9 | Nebraska | $380 | 13.6 |
| 10 | Texas | $3,700 | 12.0 |

*Source: National Conference of State Legislatures, April 2003 Report.*

**Based on 46 state responses*

**"While the nationwide recession was relatively mild, with real growth in the gross domestic product resuming a few months after the start of the recession, the fiscal crisis that struck the states was the worst since World War II[iv]"**

While the nationwide recession was relatively mild, with real growth in the gross domestic product resuming a few months after the start of the recession, the fiscal crisis that struck the states was the worst since World War II[iv]. State rainy day funds have fallen from 10 percent of states' budgets three years ago to 1 percent in late 2003[v]. For eight consecutive quarters since the second quarter of 2001, state tax revenues have fallen and states have had to make repeated downward adjustments of their budget forecasts[vi].

Minnesota's most recent budget forecast illustrates that this trend will continue for the state. The November 2003 forecast projected $407 million less in tax revenues for FY 2004 than did the February 2003 forecast[vii]. These lower revenues were partially offset by lower-than-expected expenditures, leaving a projected deficit of $185 million. Looking farther into the future, the Minnesota Department of Finance projects a $440 million deficit in 2006 and a relatively small balance of $46 million for 2007. In contrast, the previous forecast showed a $474 million balance for 2007.

The most recent budget projections continue to show slower-than-expected growth in sales and income tax revenues. The Finance Department's January economic update for FY 2004 reported that income taxes were $10 million below expectations and that sales tax receipts were $17 million below expectations[viii]. Total revenues came in close to forecasted levels, bolstered by expected increases in corporate income taxes.

For FY 2006-2007, the state predicts that expenditures will be driven by increases in the two largest portions of the budget—E-12 education (early childhood intervention through 12th grade) and health and human services. The latter category is projected to grow most rapidly, reflecting demographic trends, caseload increases, and higher utilization rates of health services. Chapter 3 of this report takes a look at health care costs and spending; Chapter 4 of this report explores the impacts of an aging population.

### *Policy issues*

Although most economic indicators suggest that the economy is in recovery, the effects of the recession on government at all levels may persist. Employment figures have not kept pace with other measures of economic growth, therefore delaying recovery in individual income and sales tax revenues. This trend may be reflected in future state budget forecasts and demand that the state make further spending and revenue adjustments.

## Budget deficit solutions

State legislatures have favored spending cuts over revenue increases to solve budget deficits[ix]. According to the National Conference of State Legislatures, 31 states cut spending to close fiscal year 2004 gaps and 14 states made across-the-board cuts[x]. State spending cuts affect local governments in different ways. The most obvious, of course, is when spending cuts include reductions in aids to cities. These cuts can significantly impact cities' capacity to provide services.

**"A recent survey of the National League of Cities, found that 24 states reduced aid to cities from 2003 to 2004 by a total of $2.3 billion, or 9.2 percent[xi]. In Minnesota, where cities receive above-average amounts of state revenues, the cuts were especially severe. The 2003-2004 LGA and MVHC reimbursement was cut 23 percent over the two years (about $311 million)."**

A recent survey of the National League of Cities, found that 24 states reduced aid to cities from 2003 to 2004 by a total of $2.3 billion, or 9.2 percent[xi]. In Minnesota, where cities receive above-average amounts of state revenues, the cuts were especially severe. The 2003-2004 LGA and MVHC reimbursement was cut 23 percent over the two years (about $311 million).

Many city officials who attended the League's fall Regional Meetings discussed the impact of the aid cuts on a wide variety of services in their communities. Cities have closed swimming pools and hockey rinks or shortened hours, delayed street repairs and seal coating, postponed purchases of new fire trucks, reduced police coverage, and cut parks maintenance. They have also reduced city hall hours, laid off city employees, eliminated vacant positions, and canceled recreation programs and events.

Cuts in other state programs can also impact cities in areas where the state and local governments share responsibility for a particular service or program. In order to balance Minnesota's 2003 state budget deficit, for example, funds were unalloted from several such programs[xii]. The clean water partnership grants and funding for septic system upgrades administered by the Minnesota Pollution Control Agency were reduced. Both of these were programs that cities had depended on for state contributions to local initiatives. Cuts to the former Department of Trade and Economic Development included reductions to the Contaminated Cleanup Fund (for preparing brownfields for development) and the Minnesota Investment Fund. The tax increment financing (TIF) deficit grant pool ($200 million) was eliminated in the 2004-2005 budget. Cities would have depended on those grants to cover deficits in their TIF districts caused in part by the 2001 tax changes.

### *Policy issues*

The severity of the aid and credit cuts to cities and severe levy limits will continue to have significant effects on cities' ability to provide services. Some of the wide range of strategies that cities have used to deal with the cuts will only alleviate budget pressure in the short-term and will require cities to make more difficult decisions in the future. Delaying repairs on streets or city buildings, for example, increases the costs of such projects. Further, city leaders in communities that used reserves to balance their budgets in the short-term will need to look at ongoing mechanisms for maintaining city operations if aid cuts are not restored.

Cities over 2,500 population have been limited in how much of the aid and credit reimbursement cuts they can replace with increases in property taxes. While the current levy limits on large cities are scheduled to expire, cities may face extended levy limits and may have to weigh further property tax and other revenue increases with permanent service reductions.

**"The federal deficit can have serious implications for state and local governments across the country, as well as for the overall economy. Cutting federal grants to states and cities as a way to reduce the deficit, for example, can create serious budget pressure for state and city governments."**

## The impact of the federal deficit

The Congressional Budget Office (CBO) projects the health of the federal budget. Its latest estimates, factoring in the recession's impact and significant tax cuts of 2001, are for federal deficits of $401 billion in fiscal year 2003 and $480 billion in fiscal year 2004[xiii]. These estimates assume that the 2001 tax law's sunset provisions will go into effect, thereby increasing federal tax revenues starting in 2005. If the tax breaks do not expire, other estimates place the federal deficit over the next 10 years at $4.6 trillion—much higher than the CBO 10-year estimate of $1.4 trillion[xiv]. The total public debt outstanding, according to the U.S. Treasury, was approximately $6.78 trillion in January 2004[xv].

The federal deficit can have serious implications for state and local governments across the country, as well as for the overall economy. Cutting federal grants to states and cities as a way to reduce the deficit, for example, can create serious budget pressure for state and city governments.

According to the National League of Cities, federal aid as a share of city revenues has declined from an average of 15 percent in 1977 to 5 percent today[xvi]. This trend is more dramatic for Minnesota cities over 2,500 population. For large Minnesota cities, federal aid as a share of total revenues went from 15 percent in 1977 to 3.5 percent in 2002, the latest year for which data is available (small city data for 1977 is not available)[xvii].

In the League of Minnesota Cities survey described in Chapter 1, the portion of cities reporting shortfalls in federal revenues grew from 4.3 percent in 2001 to 11.8 percent in 2003. The severity of the deficit—along with growing demands for Medicare, Medicaid, and Social Security, and the cost of rebuilding Iraq—will affect how well the federal government is able to meet domestic spending needs, including aid to states and cities. The deficit may impact the extent to which transfers to state and local governments are curtailed.

While cuts in federal aids have direct effects on other levels of government, the influence of the deficit on interest rates has more indirect effects. As the deficit grows, the federal government must borrow more money and, therefore, must raise the interest rate high enough to encourage investment in U.S. bonds. Different interest rates tend to increase or decrease together so if the rates on government securities increase, rates will also affect consumer spending and business growth.

***Policy issues***

Widespread increases in interest rates will push up the cost of future city borrowing and may limit future projects. Interest rate increases may positively impact some cities' budgets by boosting investment earnings.

### Looking ahead

In late 2003, most analysts and economic indicators confirmed that the economy was in recovery. Amidst reports of 8.2 percent growth in GDP during the third quarter of 2003, the outlook for the economy seemed bright. The CBO predicts GDP growth of 3.8 percent for 2004 and an increase in demand for goods by businesses. The Federal Reserve Bank's economic analysis in November highlighted a broad-based economic recovery. Consumer spending reports were positive overall and the manufacturing sector had made some improvements. The Federal Reserve also pointed to stable or even slightly improved employment figures and a continuation of a strong residential real estate market.

**"The main lingering concern about the economy is the very slow rebound of employment. While the rate of growth in GDP marked November 2001 as the end of the recession, the nationwide payroll figures did not support that conclusion[xix]."**

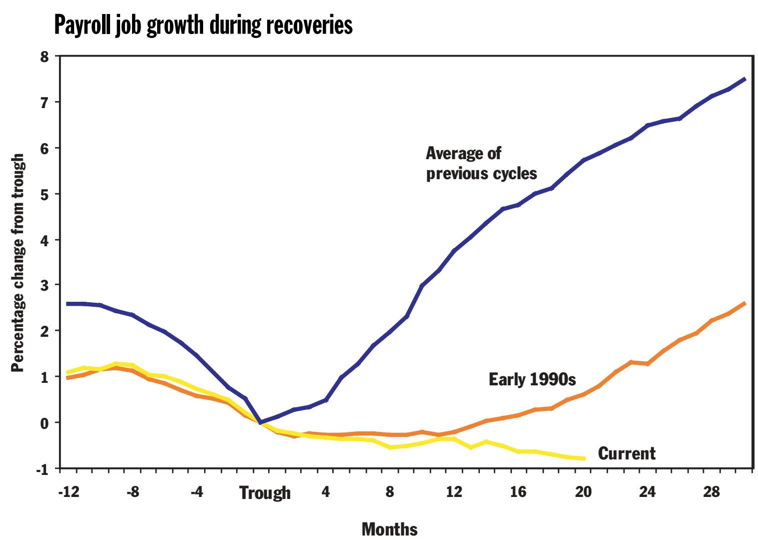
Here in Minnesota, the Minneapolis branch of the Federal Reserve reported that demand for commercial real estate in the Twin Cities was predicted to grow for the first time in two years. A 2003 Wells Fargo business survey revealed that 43 percent of responding Minnesota firms reported improved business conditions, and 54 percent of manufacturers in the Twin Cities reported improved conditions.

Some analysts urge caution, however, when looking at some of the seemingly positive economic indicators. For example, it is likely that some of the consumer spending that took place in late 2003, driving the high growth in GDP, was in fact spending that would have taken place in the future. In a sense, some of the economic growth may have been "borrowed" from future quarters as consumers were persuaded to spend sooner with low down-payment or no-interest incentives for automobiles, large durable goods, etc. The Board of Economists assembled by the Minneapolis-St. Paul *Star Tribune* pointed out that consumer demand for goods and for housing has been leading the recovery for quite some time and is likely to drop back somewhat[xviii].

The main lingering concern about the economy is the very slow rebound of employment. While the rate of growth in GDP marked November 2001 as the end of the recession, the nationwide payroll figures did not support that conclusion[xix]. For example, the GDP grew between 1 percent and 5 percent during each quarter of 2002-2003, while payroll figures actually declined 0.4 percent through July 2003.

This pattern is similar to the one seen during the recovery of the early 1990s. Both that recovery and the current one deviate from the historical trend. Prior to the recovery of the early 1990s, payroll and GDP grew together from the low point of the growth rate in GDP (the trough; see Chart 2A). In the current recovery, payroll growth is significantly slower than during recoveries prior to 1990.

**CHART 2A**




*Source: Federal Reserve Bank of New York, based on U.S. Bureau of Labor Statistics.*

**"Local government has been hit hard by job losses. Most of the losses are the result of spending reductions in the wake of cuts to LGA and MVHC and the imposition of levy limits. The local government sector has lost roughly 16,000 jobs since the start of 2003, of which 4,900 of the losses occurred between October and November."**

From early 2001 through June 2003, Minnesota lost more than 64,000 payroll jobs[xx]. This was a decrease of 2.4 percent, which outpaced the national job-loss rate of 2 percent. Employment figures published in December 2003 by the Employment and Economic Development Department showed that the state lost 7,400 jobs, more than half of the gained jobs between June and November 2003[xxi].

Local government has been hit hard by job losses. Most of the losses are the result of spending reductions in the wake of cuts to LGA and MVHC and the imposition of levy limits. The local government sector has lost roughly 16,000 jobs since the start of 2003, of which 4,900 of the losses occurred between October and November. This is about 4 percent of the total local government workforce. The *Star Tribune* Board of Economics pointed out that recovery at the national and state levels may depend partly on the extent of layoffs in state and local government. The decrease in consumer demand caused by state and local layoffs may slow the recovery.

Many cities in Minnesota, facing ongoing budget squeezes as a result of cuts in aid and other revenue shortfalls, have made decisions to lay off employees, leave positions vacant, and freeze the creation of new positions. City officials at the League's fall Regional Meetings reported that full- and part-time police officers have been laid off, parks and recreation positions have been significantly reduced, administrative positions have been cut or transitioned from full- to part-time, and police and fire positions, as well as economic development positions, have been left vacant.

### *Policy issues*

Reductions in state and local government workforces may have lingering impacts on the pace of the economic recovery through reduced sales and income tax revenues. Further, the position of cities to contribute to the state's recovery is tenuous because layoffs of city staff may make it more difficult for cities to remain competitive in initiating and supporting economic development. It may be harder to recruit businesses to a community where infrastructure upgrades have been scaled back or postponed. Similarly, it may become more challenging to attract new workers after cuts to public safety or other services.

**Endnotes**

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[vi] Reschovksy, Andrew. October 2003.

[vii] Minnesota Department of Finance, "November Forecast." November 2003.

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[xi] National League of Cities, November 2003.

[xii] State law gives the governor the authority to unallot unspent funds in order to reduce state expenditures if the state faces a deficit at the end of a biennium.

[xiii] Congressional Budget Office, "The Budget and Economic Outlook: An Update." Testimony, September 4, 2003.

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[xvii] Office of the State Auditor.

[xviii] Meyers, Mike, "Coming in 2004: Strong growth, few jobs," *Pioneer Press*, December 14, 2003.

[xix] Groshen, Erica L. and Simon Potter, "Has Structural Change Contributed to a Jobless Recovery?" Federal Reserve Bank of New York, Volume 9, Number 8, August 2003.

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# Chapter 3: Structural Economic Changes

The effects of the recession on the federal, state, and local budgets and on employment will likely be felt for some time to come. There are also several economic trends unrelated to the business cycle that are expected to persist when the economy is fully recovered. These structural changes within the economy will have important consequences for revenues and expenditures of government at all levels.

This chapter describes the following structural changes and how they are part of the overall economic and tax circumstances facing cities:
- The shift to consumption of services and the increase in electronic commerce, and the resulting erosion of sales tax revenues.
- The globalization of the economy and the competitiveness in attracting and retaining businesses.
- The rising cost of health care and the impact on government expenditures.

## Shift from goods to services

One of the most pronounced structural changes in the U.S economy is the gradual but steady shift away from goods to services. According to the Multistate Tax Commission, 47.4 percent of all consumption in 1979 was the purchase of services. By 1998, that figure had climbed to 59.1 percent[i]. This shift has significant effects on state and local revenue streams. The current sales tax system was designed decades ago and is not tailored to a global, service-driven, digital economy. In order to sustain sales tax revenues, states and local governments that impose the sales tax have two main policy options: raise the tax rate, or broaden the base to include more goods and services.

**"The current sales tax system was designed decades ago and is not tailored to a global, service-driven, digital economy. In order to sustain sales tax revenues, states and local governments that impose the sales tax have two main policy options: raise the tax rate, or broaden the base to include more goods and services."**

In most states with a sales tax, the tax is imposed on nearly all goods but on relatively few services. As services become a larger portion of consumption, the current sales tax structure will capture less economic activity. A 1992 report, "Model Revenue System for Minnesota," describes sound principles of taxation[ii]. According to the report, a model state and local revenue system should be understandable, fair (the overall distribution of taxes is progressive or at least proportional), and efficient. Such a system should be competitive for all kinds of businesses and employees. It should also be reliable to ensure that revenue grows at the same rate as personal income, thereby providing sufficient revenues.

The report recommends, based on these principles, that a sales tax system should apply the tax to all services provided primarily to consumers unless services are specifically exempted. Reducing the exclusions and exemptions from the sales tax increases the horizontal equity of the sales tax. In other words, consumers with similar consumption levels pay roughly the same amount of tax regardless of the mix of goods and services. A 2003 analysis estimates that if Minnesota were to impose a sales tax on all services except education, health care, and housing, the state could generate $1.415 billion in additional revenue[iii].

Broadening the base would help ensure that sales tax revenue remains relatively steady from year to year. When the economy is in recession, as it was recently, demand for large durable goods often declines, hurting sales tax revenues, while the demand for services remains fairly steady[iv]. Extending the sales tax to services could help prevent some fluctuation in tax receipts, alleviating some cyclical state budget pressures that lead to spending cuts, including cuts in aids to cities.

### Policy issues

The efforts of the Ventura Administration to expand the sales tax base in 2001 highlight the difficult tradeoffs involved in considering expansion of the sales tax base. Even if approached as a revenue-neutral change (i.e., broaden the base but reduce the rate to maintain the current level of revenues), any change will mean tax relief to some and tax increases to others[v]. State decision-makers may ultimately decide that shifting tax burdens among groups is an unacceptable tax increase, as they did in 2001.

### Remote sales: E-commerce

Every year, more goods are available via the Internet. The increase in e-commerce is eroding the sales tax base in two ways. First, consumers that purchase goods through e-commerce, or other remote sales such as catalog sales, do not generally pay a sales tax[vi]. Second, individuals that illegally obtain goods for free via the Internet, such as software or movies, do not pay a sales tax.

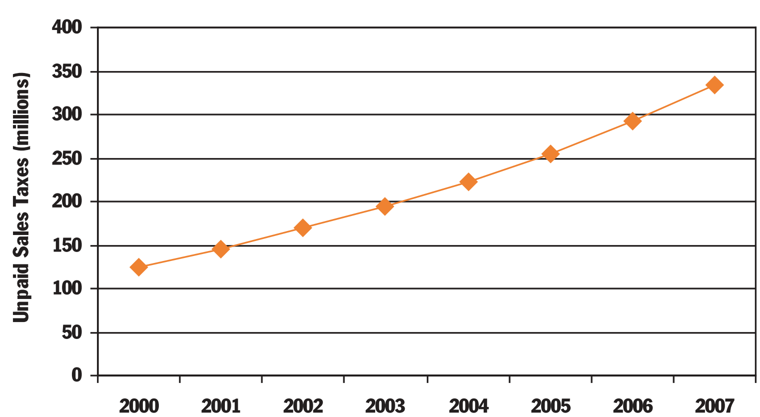
**"The Minnesota Department of Revenue estimated that e-commerce and catalog sales resulted in $125 million of unpaid sales taxes in 2000. Analysts projected that this would grow to $334 million by 2007."**

The U.S. Census Bureau estimates that e-commerce was 1.5 percent of total retail sales in the second quarter of 2003, up from 1.2 percent a year earlier. A 2001 report on this trend estimated that sales tax revenues lost nationwide, as a result of purchases made via e-commerce, totaled $13.3 billion in 2001, and would climb to $45.2 billion by 2006 and $54.8 billion by 2011[vii]. The Minnesota Department of Revenue estimated that e-commerce and catalog sales resulted in $125 million of unpaid sales taxes in 2000. Analysts projected that this would grow to $334 million by 2007 (see Chart 3A)[viii]. This unpaid sales tax is projected to grow from 3.3 percent of actual sales tax collections in 2000 to 7.4 percent in 2007.

There is a nationwide initiative underway to address some of the issues

CHART 3A

**Growth in unpaid Minnesota sales taxes due to remote sales, 2000-2007**




*Based on data from MN Department of Revenue Sales and Use Tax Gap Presentation, 2003.*

related to the current sales tax system. The Streamlined Sales Tax Project (SSTP) is an effort to reduce the inconsistencies among states regarding what items are taxed. The goal is to make charging sales tax easier for remote sellers so they will collect and remit the tax for multi-state transactions. This would help ensure that consumers who make purchases via catalog sales, Internet sales or interstate shopping pay the same tax as shoppers at local businesses.

The project involves developing uniform definitions for goods and services that all states conforming to the project will implement. Participating states will still be able to determine their tax rate and what to tax among different categories of goods established by the project. As of November 2003, 20 states had adopted the conforming legislation to participate in the project; Minnesota adopted the legislation in May 2003[ix].

***Policy issues***

The federal government will likely have the final word on whether remote sales should be taxed in the same manner as direct sales. If the SSTP is successful in reducing the difficulty retailers face in collecting sales tax on remote sales, favorable federal action is more likely. The success of the SSTP will help stabilize Minnesota's sales tax revenues and eliminate the current competitive advantage that remote retailers have over main street businesses.

Few Minnesota cities are currently authorized to impose a sales tax and most that do dedicate the revenues to regional capital projects. Cities have long advocated for a more diverse stream of revenues than property taxes and state aid. The sales tax has the advantage of exporting some of the local tax burden to consumers from outside the community that use city services. But unless the issues of remote sales and service taxation are addressed, the sales tax may not be a stable, long-term option for many cities. For many cities with little retail activity, the sales tax would not be a useful tool. For these cities, the question remains how to diversify the ways they fund services.

**"Business competitiveness no longer involves merely taking into account the tax policies and business incentives of a state or city's border communities, but of states across the country and nations across the globe."**

## Globalization

A third structural trend that is eroding government revenues is the globalization of the economy. Corporations are taking advantage of accounting strategies that involve establishing foreign headquarters or subsidiaries to reduce their tax responsibilities[x]. Jobs are increasingly shifting from one country to another, and corporations can select from almost limitless locations for establishing or expanding their business.

Businesses may make location decisions based in part on their projected tax burden in a given location. State and city officials, therefore, often examine the tax policies of neighboring jurisdictions when developing their own tax policies. Business competitiveness no longer involves merely taking into account the tax policies and business incentives of a state or city's border communities, but of states across the country and nations across the globe.

### Policy issues

Minnesota built a tradition of high-quality public services and correspondingly high taxes over the past several decades. During that time, it was a national leader on many business and quality of life indicators. But the concerns about the business sector's ability to compete in the global marketplace have led many to re-evaluate this approach. Some argue that Minnesota must be more competitive in tax rankings to retain a vital business sector and that spending on public services can be retrenched without significant damage to Minnesota's quality of life, including the infrastructure and workers upon which businesses depend.

Minnesota cities, like the state, are challenged to continue providing the services citizens and businesses have come to expect without threatening their competitiveness with lower-tax jurisdictions. The new JOBZ program may help overcome this challenge for the approximately 280 greater Minnesota cities that were designated with tax free zones. The state should carefully monitor the impact JOBZ has on development in both designated and non-designated communities.

**"The Minnesota Citizens Forum on Health Care Costs compiled data which shows that over the last four years the cost of health insurance has grown 3.5 times as fast as the state's economy and more than four times as fast as inflation."**

### Health care costs

While structural changes in the sales tax and globalization of the economy most directly impact government revenues, the trend of rising health care costs affects government expenditures. The cost of health care is a growing concern for individuals and for government at all levels. The cost of providing employee benefits will increasingly strain state and city budgets. For local officials faced with tough decisions about whether or not to increase property taxes, knowing that community members are seeing rising premiums for their health insurance makes those decisions even harder.

In a recent analysis, *Business Week* reported that total health care spending in the United States is increasing 7.3 percent each year. In 2003, $1.5 trillion was spent on health care, roughly 14 percent of the gross domestic product (GDP)[xi]. As the baby boom generation ages and the demand for health care services and for Medicare and Medicaid grows, the cost of health care will become an even more critical issue. In this section, we take an in-depth look at the impacts the aging population will have on health care spending.

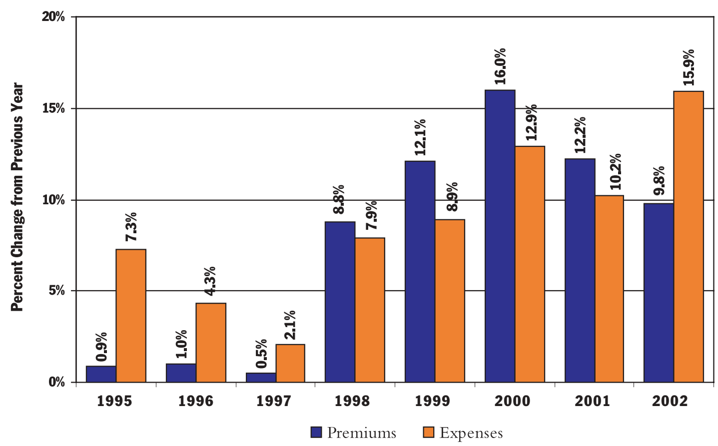
The Minnesota Citizens Forum on Health Care Costs compiled data which shows that over the last four years the cost of health insurance has grown 3.5 times as fast as the state's economy and more than four times as fast as inflation. Hospital stays and physician visits dominate spending. The cost of prescription drugs has received a lot of attention in recent years, but it remains a relatively small portion of total spending[xii]. It is, however, one of the fastest growing components of health care spending. If health care costs had risen only at the same pace in the last four years as the state economy, state and local governments would have saved as much as $1.3 billion, money that could have been spent on other services and programs[xiii].

The Minnesota Department of Health estimates that Minnesotans spent $21.6 billion on health services in 2001, and that spending has increased 41 percent between 1997 and 2000. Between 2000 and 2001, health care spending grew faster in Minnesota than in the country overall because the state experienced increased demand from low-income families as the economy slowed and because there was faster growth in demand for Medicare in Minnesota. Still, Minnesota's per capita spending on health care was $3,911 in 2000, less than the national average of $4,485[xv].

A recent Health Department report comparing actual health care cost growth and premium growth suggests that premiums may rise sharply again in the near future[xvi]. Actual cost growth and premium growth tend to occur in cycles. Historically, periods of high actual cost growth have been followed by periods of high premium growth as insurance companies recoup losses they incurred while actual costs of health care were rising. As Chart 3B shows, during 2002 actual costs grew much faster (16 percent) than did premiums (10 percent), suggesting that premiums may rise dramatically soon.

**CHART 3B**

**Commercial premium and spending trends per member, Minnesota health plans 1995-2002**




*Reprinted by permission of the Health Economics Program, Minnesota Department of Health.*

There are several contributing factors to rising health care costs. Scientific advances have made the delivery of some procedures more efficient and increased the range of medications available, thereby improving the lives of countless individuals. This has driven up utilization of those services, increasing overall costs. Finally, insurance often hides the true costs of a medical procedure or treatment from consumers. Health care consumers are often not aware of the true price of health services or medications that they use and are, therefore, not likely to choose the most cost-effective option. (Chapter 4 discusses in-depth how the aging population is an increasingly significant cost-driver.)

**"At the League's fall Regional Meetings, several cities, facing up to 25 percent increases in premiums, described exploring changing employee contribution rates or switching to health plans with higher deductibles in an effort to control costs."**

At the League's fall Regional Meetings, several cities, facing up to 25 percent increases in premiums, described exploring changing employee contribution rates or switching to health plans with higher deductibles in an effort to control costs. Consumer-driven health plans (defined contribution) are one alternative to the traditional health coverage structure. Under this kind of plan, the employer establishes a health reimbursement arrangement (HReA) for each participating employee to spend over the course of a year. Employees are able to be more involved in health care spending decisions, spending the money as if it were their own. This gives the employee an interest in spending the money efficiently, perhaps choosing generic alternatives to prescriptions or comparing treatment plans to get a competitive price.

Cities are also being innovative by establishing wellness programs in order to help participating employees improve their health and reduce costs of health care for all. Preventive care is much more economical than care for a serious medical condition or illness. Several cities have implemented points-based systems in which employees earn rewards for participating in a wide variety of health-related activities. These activities include health screenings, such as blood pressure checks, seminars on nutrition or fitness, one-time sport or fitness events such as a summer walk or a walk for charity, and tobacco-cessation programs. In some programs, employees earn points for which they receive bonus pay. In others, the points can be redeemed for additional vacation days.

Health risk management programs go further than traditional wellness or health promotion programs by identifying individual risks, and providing tailored information and behavior modification assistance to employees. They may have a positive impact on a number of different areas, including fewer employee absences and reduced medical costs. It is still unclear whether or not these programs will lead to lower premium costs.

### *Policy issues*

Spiraling health care costs are a national issue that is mostly beyond the control of the state, cities or any private employer. But cities can re-evaluate their health care plans to encourage more healthy behavior by employees, and to introduce financial incentives that encourage employees to avoid health care choices that are more expensive than necessary.

**Endnotes**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[ii] Minnesota Department of Revenue, "Model Revenue System for Minnesota," 1992.

[iii] Mazerov, Michael, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, 2003.

[iv] Mazerov, Michael, 2003.

[v] Additionally, a sales tax on services would have to be structured to assign the tax based on the residence of the consumers of the services rather than of the providers. Otherwise, Minnesota service providers would be at a competitive disadvantage to providers based in other states and Minnesota residents would have an incentive to seek non-Minnesota providers to avoid the tax.

[vi] Minnesota consumers legally owe a use tax on remote sales or sales made in other states that exceed $770 per year, but this tax is rarely remitted and enforcement is impractical. Because they are audited, businesses generally pay any use tax that they owe.

[vii] Bruce, Donald, and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," Center for Business and Economic Research, The University of Tennessee, 2001.

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# Chapter 4: Aging Population

Like the structural economic changes described in Chapter 3, the aging of the population is beyond the control of governments. The aging of the population has significant implications for government budgets and for governments as employers. Some of these effects will be felt primarily at the federal level and may have trickle-down consequences for states and cities. Others will be felt directly by cities.

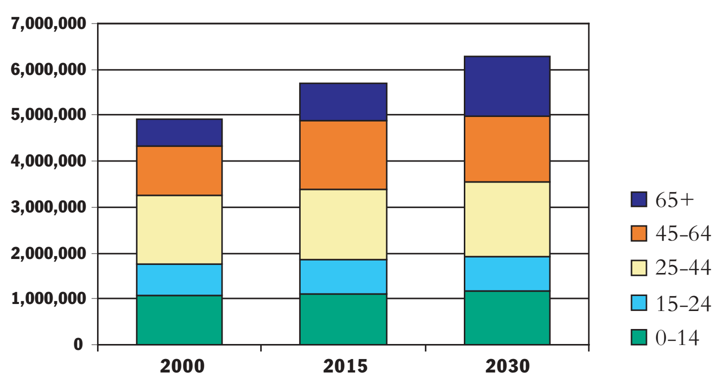
The *State of the Cities Report 2003* devoted an entire chapter to demographic changes in Minnesota, including the changes in the age distribution of the population. This chapter will take an in-depth look at how the aging population will impact different levels of government.

The baby boom generation, comprised of people between the ages of 39 and 57, is 76 million strong and the largest ever generation of Americans[i]. As the portion of the country's population over age 65 grows, it will increasingly impact the Social Security system, health care costs, and the makeup and needs of the workforce. Currently, the portion of Minnesota's population over age 65 is 12 percent but is expected to increase to 21 percent by 2030[ii] (see Chart 4A). The Social Security System Trustees' nationwide estimates roughly mirror the Minnesota pattern and predict that by 2075, 23 percent of the U.S. population will be over 65[iii].

**"The aging of the population has significant implications for government budgets and for governments as employers. Some of these effects will be felt primarily at the federal level and may have trickle-down consequences for states and cities. Others will be felt directly by cities."**

CHART 4A

**Projected age distribution of Minnesota population**




*Source: Minnesota Population Projections 2000-2030, October 2002, State Demographic Center.*

For some communities, the growing ethnic population may mitigate this trend. The ethnic population, as described in last year's *State of the Cities Report*, is younger than the white, non-Hispanic population and historically has higher birth rates. According to a recent article in the St. Paul *Pioneer Press*, based on Census reports, minorities comprised 8.8 percent of the state's labor force in 2000, up from 4.2 percent in 1990[iv]. Communities with growing numbers of young families, such as those on the edge of the metro area, may be less directly impacted by the aging of the population. Conversely, many small rural communities, especially those in western Minnesota, are already experiencing this trend.

### *Policy issues*

The *State of the Cities Report 2003* discussed several ways that the aging population may affect city services. The report found that housing and transportation are two areas in which older members of the community may demand adaptations to their changing needs. Pedestrian-friendly, mixed-use developments that are accessible by transit may be more appropriate for older citizens and transportation systems that do not rely solely on private automobiles may also be more desirable. In addition, it is possible that an aging population may demand different kinds of recreational opportunities and that cities will have to consider new recreation programming or facilities to meet the changing needs of the community.

## Impact on Social Security

Aging baby boomers will significantly impact the sustainability of the Social Security system and on the health of the federal budget. By 1965, the ratio of workers to beneficiaries was 4 to 1 and had fallen to 3.3 to 1 by 2002. The ratio is projected to be 1.9 to 1 in 2060[v].

**"Aging baby boomers will significantly impact the sustainability of the Social Security system and on the health of the federal budget. By 1965, the ratio of workers to beneficiaries was 4 to 1 and had fallen to 3.3 to 1 by 2002. The ratio is projected to be 1.9 to 1 in 2060[v]."**

As the ratio falls, fewer dollars are going into the Social Security system in the form of payroll taxes for every dollar in benefits that the system pays out. The demand for Social Security benefits will continue to increase due to the wave of aging baby boomers and longer life expectancies. The average life expectancy in the U.S. will increase from 83 today to 85 by 2035, and to 87 by 2075[vi]. In light of these trends, President Bush established the 2001 Presidential Commission to Strengthen Social Security to study reforms to the system[vii].

The strains placed on the Social Security system will affect the federal budget and may contribute to worsening budget deficits in the future. These effects could trickle down to state and local governments if other areas of spending are cut in order to absorb the rising Social Security costs. The federal government could decrease aid to states and cities, or decrease the rate at which it matches state funds for programs such as Medicare. Social Security's squeeze on the budget may also lead the federal government to consider ways to shift the responsibility and cost of certain programs to states or cities. (Chapter 5 discusses two very different mechanisms for doing this: mandates and block grants.)

### *Policy issues*

It is critical to the ability of the federal government to meet spending needs that it address the long-term Social Security deficiencies. While beyond the control of state and local governments, the drain on the federal budget of growing demands for Social Security benefits may put a squeeze on other domestic spending that more directly impacts state and local governments. States and cities may be faced with growing responsibilities for implementing federal policies if the federal government increases its use of mandates or block grants.

### Health care costs and aging

As providers of health care benefits to aging employees, cities will feel the strain of growing health care costs. Those cities that are direct providers of health care services, such as nursing homes, hospitals, and ambulance services, will also feel the strain.

The demand for health services typically rises with age[viii]. Hospitalization rates increase sharply at age 55. Health care spending for an individual over 65 in 2000 was typically three times the amount spent for a younger person. As the baby boomers age, they will significantly impact the demand for health care. The Minnesota Department of Health's 2003 analysis suggests that by 2030 more than half of the increase in hospitalization and inpatient days will be due to the changing age distribution of the population. Right now, population growth is still the primary driver of increased utilization of these health services.

Experts predict that the need for geriatricians, home health care aides, nursing home aides, and long-term care specialists will grow dramatically[ix]. As the proportion of the population over age 65 grows and as people live longer, the strain on the capacities of hospitals, clinics, and the supply of health care workers will increase. Cities that currently provide nursing home or hospital services will feel this strain. Depending on the capacity of the private sector to supply adequate health care facilities, cities may be faced with decisions about what kinds of facilities, such as nursing homes, to provide for their communities.

Cities, like other employers, will also face increasing health care costs for aging workers. Employees who retire before age 65 remain in the same insurance pool as active employees. Since health care demands increase with age, the cost of claims made by early retirees may have an upward pressure on all city employees' premiums costs. Retirees are permitted by state law to remain on cities' health insurance plans as long as they pay the full premium. Some cities, however, due to collective bargaining agreements, pay a portion of the premium for retirees over age 65. These cities may see an increase in their premiums as the costs of claims made by retired workers increases.

#### *Policy issues*

In areas of the state where the private sector is not adequately meeting the growing demand for health care services, the state and/or cities may need to fund the construction and operation of nursing homes, hospitals, and ambulance services. For cities that begin funding such facilities, the possibility of additional market failures of privately-owned facilities will put added strains on their budgets.

The possibility of a health care workforce shortage has implications for both the state and for cities. The state may need to consider increasing incentives for individuals to enter the health care profession and providing the educational programs they will require. Cities that operate existing health care facilities or choose to establish them will need to take steps to attract health care workers, such as increasing the affordable housing stock.

**"As providers of health care benefits to aging employees, cities will feel the strain of growing health care costs. Those cities that are direct providers of health care services, such as nursing homes, hospitals, and ambulance services, will also feel the strain."**

## Workforce and aging

As the population ages, so does the workforce. The public sector may be the bellwether for the private sector on this issue. Nationwide, 46.3 percent of government workers are age 45 or older, but only 31.2 percent of private employees are in this age group[x]. Employers, including cities, will be challenged to retain older workers by offering flexible scheduling, phased-in retirement, and equipment or facility adjustments.

According to research by the American Association of Retired Persons (AARP), eight in 10 baby boomers plan to work at least part-time after turning 65[xi]. Many who are planning to work past the traditional retirement age are doing so because of the hit that investments took during the recession. The AARP research also suggests that many older Americans plan to continue working because of the personal fulfillment they find in their jobs.

Maintaining an adequate workforce as older workers fully retire will become a critical issue. For employers, including cities, it will be a challenge to replace older, highly experienced workers with younger employees. Often, the oldest workers are in positions requiring extensive training or education.

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For cities, retaining highly experienced workers may become more problematic as salary competition with the private sector grows. Some of the most experienced and talented employees are moving to other states or to the private sector, in part because they have reached the state-imposed salary cap. Early retirement incentives presented to employees as a strategy for dealing with state aid cuts may exacerbate cities' struggles to maintain a skilled workforce.

Employers may consider ways to keep older workers in their jobs or entice retired workers back to work in order to lessen their need for succession planning and training of new workers. Reports on the aging workforce describe employer efforts to retain older workers and to recruit retirees. Strategies that employers have used include offering a range of flexible scheduling options, allowing job-sharing, redesigning pension plans to reward working past the traditional retirement age, and allowing individuals to have a phased-in retirement[xii].

As baby boomers retire, fewer workers are projected to join the labor force to replace them. The labor force is growing at a slower rate than the retiree population. The Minnesota State Demographic Center projects that the growth rate of the labor force[xiii], currently forecasted to be 16 percent until 2010, will slow significantly after 2010 since the generation following the baby boomers is much smaller[xiv]. Labor force growth will fall to 6 percent between 2010 and 2020, and to 3 percent between 2020 and 2030. Demographers forecast that while in the next few years job shortages will be the trend, a worker shortage will be the critical issue in the long-term.

Certain legislative actions can intensify employers' struggles to retain an adequate labor force. For example, recent cuts to state childcare assistance may create significant barriers to entering or remaining in the workforce. If the lack of access to childcare prevents younger workers from entering the labor force, this will affect the ability of employers to meet their workforce demands.

The competition between states to attract "knowledge-workers," graduates who are entrepreneurs or skilled in such fields as science and biotechnology, will affect Minnesota's ability to revitalize its workforce and be a "brain-gain" state. There is competition between cities to attract these kinds of workers.

Recent work cited by the *Washington Post* suggests that college graduates are gravitating to areas heavy in amenities like public transportation, recreational opportunities, and vibrant art scenes. The Minneapolis-St. Paul area is listed among the top metropolitan areas boasting of a large diverse population of highly-educated residents who actively take advantage of and foster the area's art and culture scene[xv].

The metropolitan area, however, is not the only place to which people are drawn. The *State of the Cities Report 2003* described migration trends between 1990 and 2000 across Minnesota. According to Census data, younger people migrated to counties in the high-growth corridor from the St. Cloud area to the southeast corner of the state and to the metro area. Counties on the western border and in the southwest corner of the state experienced net out-migration in the 1990s. Among older Minnesotans, there was significant net-migration to the Lake counties.

**"The competition between states to attract "knowledge-workers," graduates who are entrepreneurs or skilled in such fields as science and biotechnology, will affect Minnesota's ability to revitalize its workforce and be a "brain-gain" state. There is competition between cities to attract these kinds of workers."**

### *Policy issues*

Cities will need to explore their options for retaining older workers and appealing to retirees to return to the workforce. Changes to employer policies, such as allowing telecommuting and flexible scheduling, may become necessary in order to maintain a skilled workforce. Cities may want to seek changes to retirement plans that would allow employees at or near retirement age to continue to work on a reduced schedule while beginning to collect their full retirement benefit. Such a change would allow the city to retain an experienced staff that would otherwise opt for full retirement.

In looking to ensure an adequate workforce, the state should pursue policies that encourage individuals to join or re-enter the workforce.

The state and cities are competing with other amenity-rich areas for young, skilled professionals. Both the state and cities will need to examine the cultural, recreational, and transportation opportunities that they make available in order to be competitive in attracting and retaining skilled workers. The metropolitan area may have an advantage in attracting these workers, while some cities outside the metropolitan area may face additional barriers in attracting workers and growing their economies.

**Endnotes**


i National Governors Association, "The Aging Initiative: State Policies for the Twenty-First Century," 2003.

ii Minnesota Demographic Center, "Population Projections 2000-2030," 2002.

iii Social Security Administration, "The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds," 2003.

iv *Pioneer Press,* "Minority Work Force Up," December 30, 2003.

v Employee Benefit Research Institute, "The Basics of Social Security Updated with the 2003 Board of Trustees Report," May 2003.

vi Social Security Administration, 2003.

vii See the President's Commission to Strengthen Social Security at: **www.csss.gov**

[viii] Minnesota Department of Health, Health Economics Program, "Minnesota's Aging Population: Implications for Health Care Costs and System Capacity," August 2003.

[ix] National Governors Association, 2003.

[x] Abbey, Craig W. and Donald J. Boyd, "The Aging Government Workforce," The Nelson A. Rockefeller Institute of Government, July 2002.

[xi] National Governors Association, 2003.

[xii] United States General Accounting Office, "Older Workers: Demographic Trends Pose Challenges for Employers and Workers," Report to the Ranking Minority Member, Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, House of Representatives, November 2001.

[xiii] The labor force population is defined as people who are either employed, temporarily absent from work or laid off, or seeking work.

[xiv] Minnesota Demographic Center, " Minnesota Labor Force Projections 2000-2030," February 2003.

[xv] Florida, Richard, *The Rise of the Creative Class*, Basic Books: 2002.

# Chapter 5: Federalism in Peril

States and cities have experienced the recent fiscal crisis against the backdrop of a changing relationship between the federal, state, and city governments. Throughout the history of federalism in the United States, there have been different ideas for the ideal distribution of responsibilities among the levels of government. In practice, the federal system is the collective impact of hundreds of decisions by federal, state, and local governments on how to achieve public policy goals.

These decisions inevitably lead to the exercise of authority by higher levels of government on lower levels of government. Further, how much autonomy states should have to set policy goals is at the core of the states' rights debate, as it has been since the country's founding. The federalism debate often hinges on whether uniformity among state and local governments in implementing federal policy goals is preferable to tailored implementation and experimentation by states and cities. There also arises frequent conflict between the goals of efficiency in delivery and management of a program and equity in serving the unique needs of those using a particular service in different locations.

**"The federalism debate often hinges on whether uniformity among state and local governments in implementing federal policy goals is preferable to tailored implementation and experimentation by states and cities."**

These policy debates almost always include a fiscal element. For example, in considering policy implementation, matching policy responsibility with raising revenues for a particular program is one issue. Other questions that arise are whether or not mandates include full funding and if strictures preclude more cost effective ways to achieve policy goals.

A recent roundtable discussion on federalism hosted by the National League of Cities (NLC) featured academics, representatives from public policy associations, and federal, county, and city officials[i]. The group concluded that the intergovernmental partnership is currently in peril. The report based on the NLC roundtable suggested that this is the critical point for beginning to renew and strengthen the relationship between the federal government, states, and cities.

This chapter examines several dysfunctional aspects of the current federal system, including unpredictability in direct transfers to states and cities, and the move towards increasing uses of mandates and block grants. These issues are manifestations of the breakdown of meaningful communication and partnership among the levels of government.

The combined impacts of the war on terrorism and the ongoing conflict in Iraq may diminish the role that the federal government plays in future funding of domestic government programs. Burgeoning claims for federal entitlement programs like Social Security and Medicare will put tremendous pressure on the federal budget. Pressure may increase on the federal government to address future policy issues through mandates on lower levels of government if it does not have the money to address issues itself. These pressures may also lead to reductions in grants to states and cities and lower federal matching rates for programs like Medicaid (public health insurance for low-income individuals).

The significant federal tax cuts passed by Congress in the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) will reduce federal tax receipts by roughly $1.35 trillion by 2010[ii]. The impact of EGTRRA, however, will not only be felt at the federal level, but in states that experience a drop in tax revenues because they conform their tax codes to the federal tax code.

In light of severe budget pressures and consistent with its views of federalism, the current administration favors shifting responsibility for various programs and services to the states by way of federal mandates and block grants. State and local governments, therefore, are caught between decreasing tax receipts and cuts in aids on the one hand, and increasing demand for services in healthcare, education, and social services on the other[iii].

### *Policy issues*

The American federal system has been described as evolving from a "layer cake" where there were clear lines of responsibility for public policy issues among the federal, state and local governments to a "marble cake" where various program responsibilities and funding are shared among the levels of government. Since the 1980s, the federal government's role in funding programs at the local level has diminished, but federal financing of state programs and federal regulatory oversight and programmatic mandates on state and local governments have increased.

**"While the budget crises at the state and local level have been partly caused by the economic downturn, state and local budgets are also strained by demands placed upon them through the use of mandates by higher levels of government."**

### Mandates

While the budget crises at the state and local level have been partly caused by the economic downturn, state and local budgets are also strained by demands placed upon them through the use of mandates by higher levels of government. These mandates may or may not be accompanied by sufficient funding to carry out the required actions. Mandates can be a way for one level of government to shift responsibility and cost for a certain program or service to another. Often the most expensive mandates involve our most important national policy issues, such as education, public safety, and the environment.

At the recent NLC roundtable discussion, city leaders commented that each time the terror threat is raised, it costs cities across the country about $70 million under the homeland security requirements[iv]. Participants also pointed out that one of the major problems with mandates in general is that the public does not know which level of government is ultimately responsible for a given service. City officials at the roundtable also highlighted the contradiction between the increasing use of unfunded mandates and the increasing pre-emption of local control in areas such as business taxation. In some areas, higher levels of government seek to shift responsibilities and costs to lower levels of government, while, in others, they seek to retain control while often restricting revenue-raising authority.

Congress passed the Unfunded Mandate Reform Act (UMRA) in 1995, a signal that intergovernmental communication about needs and capacities had broken down. The Act requires the Congressional Budget Office to prepare estimates of the costs that would be incurred by lower levels of government as a result of a particular mandate. It does not prevent legislation from becoming law; it only ensures that the cost burdens are made explicit. Critics of UMRA point out that it does not protect states and local governments from some types of burdensome mandates, such as when states or cities are forced into certain actions by court orders[v].

Additionally, UMRA does not apply to conditions for federal aid. The No Child Left Behind Act (NCLB) is a good illustration. While this legislation is not technically structured as a mandate, school districts are left without any real choice in following the law because they lose federal funding if they do not. In this way, proponents of an expanded UMRA claim that legislation such as NCLB is "under the radar."

Attaching new policy requirements to existing revenue streams is not an invention of the current administration. The previous administration made federal transportation dollars contingent on states' reducing their impaired-driving standards to a blood alcohol level of 0.08, potentially leading to higher costs for state and local courts and law enforcement. Other administrations, both Republican and Democratic, have acted similarly.

At the state level, Minnesota law outlines a process for the preparation of local fiscal notes for proposed legislation that significantly increases costs on local governments. While the law does not prohibit the passage of mandates, it can be an effective tool for communicating to legislators the potential costs of a proposed law. Minnesota law also allows local governments to challenge state rules if they can achieve the goal of the rule in a more cost-effective manner.

***Policy issues***

Mandates are probably an inevitable feature of the federal-state-local system. Open communication among levels of government in crafting policies is critical in minimizing the negative impacts of mandates and in effectively achieving the policy goals. Barring that, the federal government should consider whether UMRA should apply to court-ordered actions and to conditions for federal aid.

**"The current administration has proposed transitioning several federal spending items, such as Head Start and Section 8 (voucher) housing programs, into block grants that would move control over program administration and spending from local governments to states."**

## Shared responsibility

The current administration has proposed transitioning several federal spending items, such as Head Start and Section 8 (voucher) housing programs, into block grants that would move control over program administration and spending from local governments to states. The stated rationale behind this strategy is that states may be able to administer the programs more efficiently and provide better quality service. Critics have charged that reducing federal domestic spending is the primary motivation.

Several participants in the recent NLC roundtable discussion highlighted serious concerns about the block grant proposals. If the funding is not adjusted for inflation, over time the program either serves fewer people or delivers services of poorer quality. Another concern is that block grant funding may be more vulnerable to budget cuts than categorical spending. Participants also mentioned that after transition to a block grant, the federal government could increase the regulations associated with the grant, potentially making it more costly to deliver the service and reducing flexibility. Also, when states have authority over a program, they may change eligibility standards to control spending or alter the allocation of funding, creating significant changes for grant recipients from year to year. Finally, if programs over which cities have current authority are transitioned to state block grants, the distribution of funding and control could change dramatically.

***Policy Issues***

Block grants can be an effective tool for the federal government to provide funding to state governments to achieve a broad policy goal through state-developed programming. Cities may lose discretion, however, if the block grant replaces existing local-government discretion with uniform state programming. Block grants can also be a way for the federal government to assign a fixed appropriation to a program with ever-increasing costs or demands.

## State and local governments as innovators

As a result of the fiscal crises plaguing states and the ensuing close attention to budgets, state policy-makers have less time to devote to developing creative policy solutions to ongoing problems. There is also very little money available in state budgets to get new projects or programs off the ground.

A recent analysis of this phenomenon in *Governing Magazine,* suggests that the downturn in idea generation by state governments is a more critical issue today given that the federal government is not currently putting forth new policy ideas[vi]. The discussion points out that a generation ago, the federal government established the interstate highway system, implemented Medicaid and Medicare, waged a War on Poverty, and set up the Environmental Protection Agency. When federal deficits hit during the 1970s, idea generation slowed dramatically and has not recovered. The report predicts that the only major initiative of the federal government will be a prescription drug benefit plan, which it estimates will be very expensive and not benefit state budgets.

**"Constraints on city revenues can deter innovation. These constraints include tight regulations on how funding is used and distributed, and restrictions on what kinds of revenue can be raised."**

Constraints on city revenues can deter innovation. These constraints include tight regulations on how funding is used and distributed, and restrictions on what kinds of revenue can be raised. In Minnesota, cities over 2,500 population have been subject to levy limits for 25 of the last 31 years. State law also governs what other revenues cities are allowed to implement. These constraints, along with reductions in federal and state-shared revenues, have changed how cities fund services over time.

Some observers believe that revenue constraints can encourage innovation and new efficiencies. The evidence of this collected for this report is mixed. Survey respondents and roundtable participants indicate that recent budget challenges have encouraged many cities to take a fresh look at opportunities to contract or privatize services, increase productivity, and engage in cooperative service agreements with other jurisdictions. Some participants have acknowledged that significant revenue shocks have enabled them to make politically difficult choices to explore new efficiencies. Yet the survey demonstrates that cities have engaged in cooperative service efforts for a long time. These arrangements often result in cost savings to the public, although they may be realized in the long-term. There can be short-term cost increases. In such cases, revenue shortfalls can be a barrier to, rather than a spur of, innovation.

At the same time, many cities have responded to recent revenue constraints with strategies that may inhibit innovation in the long run. Many cities are delaying capital investments, depleting reserves, eliminating promising programs, and cutting staff training and education budgets.

In any event, revenue restrictions and shortfalls are only half of the equation. Local innovation and creativity are stifled by federal and state restrictions on regulatory or other local authority. For example, interest groups lobby the state and federal government to require uniform municipal regulations of business activity or to pre-empt local authority over zoning policies. While uniformity does provide ease of navigation from one location to another, it also hinders the creation of policies that take into account unique local circumstances and citizen preferences.

### *Policy issues*

The tension between nationwide or statewide uniformity and local control is inherent in this country's system of shared federal-state-local responsibility. Many advocates of local control acknowledge that for some public policy issues, a certain level of uniformity is necessary. But the continual erosion of local control by the federal and state governments inhibits local elected officials from tailoring policy solutions based on the unique circumstances of their communities. It also threatens to stifle the creative problem-solving that leads to the development of best practices that then get shared with governments across the nation.

**Endnotes**

[i] The National League of Cities roundtable participants were: Karen Anderson, mayor, Minnetonka, Minn., former president, NLC; Geoffrey Beckwith, executive director, Massachusetts League; Donald Borut, executive director, NLC; Henry Cisneros, chairman/CEO, American City Vista; John DeStefano, president, NLC, mayor, New Haven, Conn; Douglas Duncan, Montgomery County executive; Paul Helmke, former mayor, Fort Wayne, Ind.; Bruce Hunter, associate executive director, American Association of School Administrators; Michael Pagano, professor, Public Administration, University of Illinois; Scott Pattison, executive director, National Association of State Budget Officers; Paul Posner, managing director, Federal Budget Analysis, Strategic Issues, Government Accounting Office; Barbara Sard, director, Housing Policy, Center on Budget and Policy Priorities; Ray Scheppach, executive director, National Governors Association; Margy Waller, visiting fellow, Brookings Institution; Anthony Williams, second vice-president, NLC, mayor, Washington, D.C.

[ii] Burman, Leonard E., Jeff Rohaly, and Elaine Maag. "EGTRRA: Which Provisions Spell the Most Relief?" Urban Institute, 2002.

[iii] In May 2003, Congress did approve temporary fiscal relief funding for the states. Some of the relief comes in the form of a temporary increase in the federal matching rate for state Medicaid dollars. The remainder is general fiscal relief that states may use for any purpose that was included in their most recent budgets.

[iv] National League of Cities, "Is the Federal-State-Local Partnership Being Dismantled? A Summary of a National League of Cities Roundtable Discussion," 2003.

[v] Nivola, Pietro S., "Fiscal Millstones on the Cities: Revisiting the Problem of Federal Mandates," The Brookings Institution, 2003.

[vi] Kettl, Donald F., "Innovation Freeze," *Governing Magazine*, October 2003.

# Appendix:
# Minnesota Cities by Clusters

### 15 City Clusters Methodology

A detailed description of how the 15 city clusters were derived is available online in the Policy Research section of the LMC web site at: **www.lmnc.org**.

**M Central Cities**
Minneapolis
St Paul

**M Large Cities**
Apple Valley
Blaine
Bloomington
Brooklyn Park
Burnsville
Coon Rapids
Eagan
Eden Prairie
Edina
Maple Grove
Minnetonka
Plymouth

**M Old Cities**
Anoka
Brooklyn Center
Columbia Heights
Crystal
Hastings
Hopkins
New Brighton
New Hope
Richfield
Shoreview
South St Paul
West St Paul
White Bear Lake

**M Diversified**
Arden Hills
Coates
Forest Lake
Fridley
Gem Lake
Golden Valley
Lilydale
Long Lake
Maple Plain
Maplewood
Oak Park Heights
Osseo
Roseville
St Louis Park
Wayzata

**M High Growth**
Andover
Carver
Centerville
Champlin
Chanhassen
Chaska
Cologne
Cottage Grove
East Bethel
Elko
Farmington
Greenfield
Ham Lake
Hugo
Inver Grove Heights
Lakeville
Lino Lakes
Mahtomedi
Medina
Mendota Heights
New Market
Oak Grove
Oakdale
Prior Lake
Ramsey
Rogers
Rosemount
Savage
Shakopee
St Bonifacius
St Francis
Vadnais Heights
Victoria
Waconia
Woodbury

**M High Income**
Afton
Birchwood
Corcoran
Deephaven
Dellwood
Grant
Greenwood
Independence
Lake Elmo
Lakeland
Lakeland Shore
Minnetonka Beach
Minnetrista
North Oaks
Orono
Pine Springs
Shorewood
Sunfish Lake
Tonka Bay
Woodland

**M Smaller Cities**
Bayport
Belle Plaine
Bethel
Circle Pines
Dayton
Excelsior
Falcon Heights
Hamburg
Hampton
Hilltop
Jordan
Lake St Croix Beach
Landfall
Lauderdale
Lexington
Little Canada
Loretto
Marine on St Croix
Mayer
Medicine Lake
Mendota
Miesville
Mound
Mounds View
New Germany
New Prague
New Trier
Newport
North St Paul
Norwood Young America
Randolph
Robbinsdale
Spring Lake Park
Spring Park
St Anthony Village
St Marys Point
St Paul Park
Stillwater
Vermillion
Watertown
Willernie

**GM Major Cities**
Duluth
Rochester
St Cloud

**GM Regional Centers**
Albert Lea
Austin
Bemidji
Brainerd
Cloquet
Fairmont
Faribault
Fergus Falls
Hibbing
Hutchinson
Little Falls
Mankato
Marshall
Moorhead
New Ulm
Northfield
Owatonna
Red Wing
Virginia
Willmar
Winona
Worthington

**GM Sub-Regional Centers**
Aitkin
Alexandria
Appleton
Baudette
Baxter
Cambridge
Deerwood
Detroit Lakes
Grand Marais
Grand Rapids
Hinckley
International Falls
Long Prairie
Mahnomen
Mora
Motley
Park Rapids
Pequot Lakes
Perham
Pine City
Pine River
Princeton
Roseau
Spicer
Waite Park
Walker
Warroad

**GM Urban Fringe**
Albertville
Becker
Big Lake
Breezy Point
Isanti
North Branch
Rockville
Sartell
St Michael
Zimmerman

**GM High Income**
Avon
Buffalo
Byron
Cannon Falls
Clearwater
Courtland
Crosslake
Delano
Dundas
East Gull Lake
Elk River
Hanover
Hermantown
La Prairie
Mantorville
Medford
Monticello
Nisswa
North Mankato
Oronoco
Otsego
Rice
Sauk Rapids
St Augusta
St Stephen
Wyoming

**GM Moderate Growth**
Annandale
Brownsville
Buffalo Lake
Center City
Chatfield
Chisago City
Cohasset
Cokato
Cold Spring
Cottonwood
Dassel
Dodge Center
Emily
Eyota
Foley
Gaylord
Glencoe
Glyndon
Goodhue
Goodview
Harris
Henderson
Holdingford
Howard Lake
Isle
Kasson
Kenyon
La Crescent
Lake City
Lake Shore
Le Center
Le Sueur
Lester Prairie
Lewiston
Lindstrom
Lonsdale
Madison Lake
Maple Lake
Nicollet
Pine Island
Plainview
Redwood Falls
Richmond
Rockford
Rush City
Rushford
Sandstone
Sauk Centre
St Charles
St Clair
St Joseph
Stacy
Stewartville
Stockton
Taylors Falls
Wanamingo
Waverly
Winsted
Zumbrota

**GM Established**
Ada
Adams
Adrian
Albany
Alden
Amboy
Argyle
Arlington
Atwater
Aurora
Babbitt
Bagley
Balaton
Barnesville
Barnum
Battle Lake
Belgrade
Benson
Bird Island
Biwabik
Blackduck
Blooming Prairie
Blue Earth
Bovey
Braham
Breckenridge
Brewster
Brooten
Browerville
Browns Valley
Brownsdale
Brownton
Buhl
Butterfield
Caledonia
Canby
Carlton
Cass Lake
Chisholm
Clara City
Claremont
Clarissa
Clarkfield
Clarks Grove
Clearbrook
Cleveland
Coleraine
Cook
Cosmos
Crookston
Crosby
Danube
Dawson
Deer River
Dilworth
Eagle Bend
Eagle Lake
East Grand Forks
Eden Valley
Edgerton
Elbow Lake
Elgin
Ellendale
Ellsworth
Elmore
Ely
Evansville
Eveleth
Fairfax
Fertile
Floodwood
Fosston
Frazee
Fulda
Gibbon
Gilbert
Glenville
Glenwood
Good Thunder
Graceville
Grand Meadow
Granite Falls
Greenbush
Grove City
Hallock
Halstad
Hancock
Harmony
Hawley
Hayfield
Hector
Hendricks
Henning
Heron Lake
Hills
Hoffman
Hokah
Houston
Hoyt Lakes
Ivanhoe
Jackson
Janesville
Jasper
Kandiyohi

Karlstad
Kasota
Keewatin
Kerkhoven
Kiester
Kimball
Lafayette
Lake Benton
Lake Crystal
Lake Park
Lakefield
Lamberton
Lanesboro
Le Roy
Litchfield
Littlefork
Luverne
Lyle
Mabel
Madelia
Madison
Mapleton
Marble
Mazeppa
Mc Intosh
Melrose
Menahga
Milaca
Minneota
Minnesota Lake
Montevideo
Montgomery
Montrose
Moose Lake
Morgan
Morris
Morristown
Mountain Iron
Mountain Lake
Nashwauk
New London
New Richland
New York Mills
Olivia
Onamia
Ortonville
Osakis
Parkers Prairie
Paynesville
Pelican Rapids
Pennock
Pierz
Pipestone
Preston
Proctor
Randall
Raymond
Red Lake Falls
Renville
Rock Creek
Rollingstone
Royalton
Rushford Village
Sacred Heart
Scanlon
Sebeka
Sherburn
Silver Bay
Silver Lake
Slayton
Sleepy Eye
Spring Grove
Spring Valley
Springfield
St James
St Peter
Staples
Starbuck
Stephen
Stewart
Thief River Falls
Tracy
Trimont
Truman
Twin Valley
Two Harbors
Tyler
Ulen
Verndale
Wabasha
Wabasso
Wadena
Walnut Grove
Warren
Waseca
Waterville
Watkins
Welcome
Wells
West Concord
Westbrook
Wheaton
Windom
Winnebago
Winthrop

**GM Small Cities**

Akeley
Alberta
Aldrich
Alpha
Altura
Alvarado
Arco
Ashby
Askov
Audubon
Avoca
Backus
Badger
Barrett
Barry
Beardsley
Beaver Bay
Beaver Creek
Bejou
Bellechester
Bellingham
Beltrami
Belview
Bena
Bertha
Big Falls
Bigelow
Bigfork
Bingham Lake
Biscay
Blomkest
Bluffton
Bock
Borup
Bowlus
Boy River
Boyd
Brandon
Bricelyn
Brook Park
Brooks
Brookston
Bruno
Buckman
Burtrum
Callaway
Calumet
Campbell
Canton
Carlos
Cedar Mills
Ceylon
Chandler
Chickamaw Beach
Chokio
Clear Lake
Clements
Climax
Clinton
Clitherall
Clontarf
Cobden
Comfrey
Comstock
Conger
Correll
Cromwell
Currie
Cuyuna
Cyrus
Dakota
Dalton
Danvers
Darfur
Darwin
De Graff
Deer Creek
Delavan
Delhi
Denham
Dennison
Dent
Dexter
Donaldson
Donnelly
Doran
Dover
Dovray
Dumont
Dundee
Dunnell
Easton
Echo
Effie
Eitzen
Elba
Elizabeth
Elkton
Elmdale
Elrosa
Elysian
Emmons
Erhard
Erskine
Evan
Farwell
Federal Dam
Felton
Fifty Lakes
Finlayson
Fisher
Flensburg
Florence
Forada
Foreston
Fort Ripley
Fountain
Foxhome
Franklin
Freeborn
Freeport
Frost
Funkley
Garfield
Garrison
Garvin
Gary
Geneva
Genola
Georgetown

**GM Small Cities, continued**

Ghent
Gilman
Gonvick
Goodridge
Granada
Grasston
Green Isle
Greenwald
Grey Eagle
Grygla
Gully
Hackensack
Hadley
Halma
Hammond
Hanley Falls
Hanska
Harding
Hardwick
Hartland
Hatfield
Hayward
Hazel Run
Heidelberg
Hendrum
Henriette
Herman
Hewitt
Hill City
Hillman
Hitterdal
Holland
Hollandale
Holloway
Holt
Humboldt
Ihlen
Iona
Iron Junction
Ironton
Jeffers
Jenkins
Johnson
Kelliher
Kellogg
Kennedy
Kenneth
Kensington
Kent
Kerrick
Kettle River
Kilkenny
Kinbrae
Kingston
Kinney
La Porte
La Salle
Lake Bronson
Lake Henry
Lake Lillian
Lake Wilson
Lancaster
Lastrup
Lengby
Leonard
Leonidas
Lewisville
Lismore
Long Beach
Longville
Louisburg
Lowry
Lucan
Lynd
Magnolia
Manchester
Manhattan Beach
Mapleview
Marietta
Maynard
Mc Grath
Mc Gregor
Mc Kinley
Meadowlands
Meire Grove
Mentor
Middle River
Milan
Millerville
Millville
Milroy
Miltona
Minneiska
Minnesota City
Mizpah
Morton
Murdock
Myrtle
Nashua
Nassau
Nelson
Nerstrand
Nevis
New Auburn
New Munich
Newfolden
Nielsville
Nimrod
Norcross
Northome
Northrop
Odessa
Odin
Ogema
Ogilvie
Okabena
Oklee
Ormsby
Orr
Oslo
Ostrander
Ottertail
Palisade
Pease
Pemberton
Perley
Peterson
Pillager
Plato
Plummer
Porter
Prinsburg
Quamba
Racine
Ranier
Regal
Remer
Revere
Richville
Riverton
Ronneby
Roosevelt
Roscoe
Rose Creek
Rothsay
Round Lake
Rushmore
Russell
Ruthton
Rutledge
Sabin
Sanborn
Sargeant
Seaforth
Sedan
Shafer
Shelly
Shevlin
Skyline
Sobieski
Solway
South Haven
Spring Hill
Squaw Lake
St Anthony
St Hilaire
St Leo
St Martin
St Rosa
St Vincent
Steen
Storden
Strandquist
Strathcona
Sturgeon Lake
Sunburg
Swanville
Taconite
Tamarack
Taopi
Taunton
Tenney
Tenstrike
Thomson
Tintah
Tower
Trail
Trommald
Trosky
Turtle River
Twin Lakes
Underwood
Upsala
Urbank
Utica
Vergas
Vernon Center
Vesta
Viking
Villard
Vining
Wahkon
Waldorf
Walters
Waltham
Wanda
Warba
Watson
Waubun
Wendell
West Union
Westport
Whalan
Wilder
Williams
Willow River
Wilmont
Wilton
Winger
Winton
Wolf Lake
Wolverton
Wood Lake
Woodstock
Wrenshall
Wright
Wykoff
Zemple
Zumbro Falls

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