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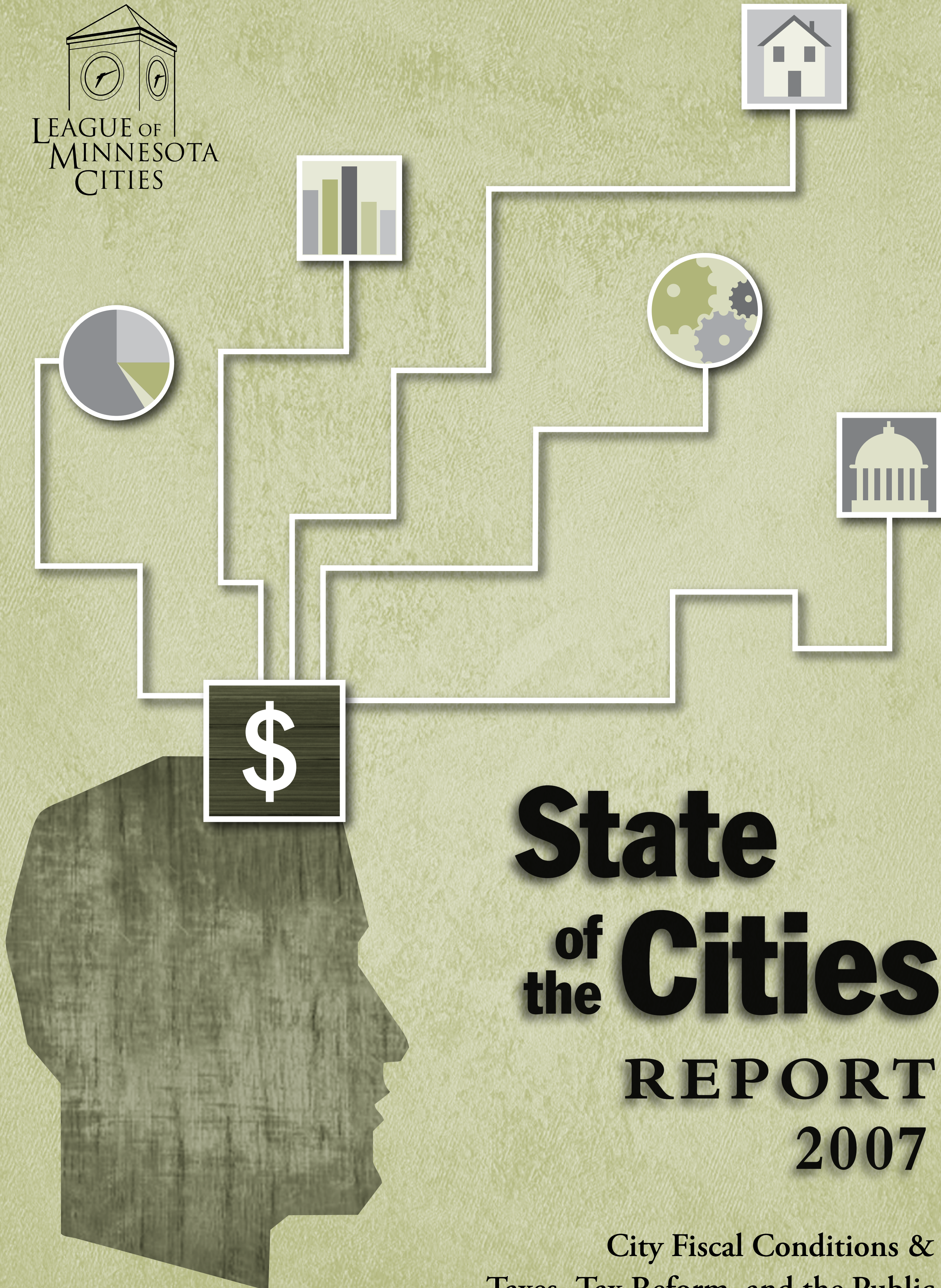

State of the Cities Report 2007

City Fiscal Conditions &
Taxes, Tax Reform, and the Public

League of Minnesota Cities

State of the Cities

REPORT

2007

State of the Cities Report 2007

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Kimberly Winn, League of Kansas Municipalities
Arnold Weinfeld, Michigan Municipal League
Stuart Haynes, Missouri Municipal League
Mary Beth Lake, Pennsylvania League of Cities and Municipalities
Yvonne Taylor, Carrie Weber, and Christine Hibbeler, South Dakota Municipal League
Mona Lawrence and Margaret Mahery, Tennessee Municipal League
Lisa Dooley, West Virginia Municipal League
National Conference of State Legislatures

The League of Minnesota Cities is a non-profit, membership organization dedicated to promoting excellence in local government through effective advocacy, expert analysis, and trusted guidance for all Minnesota cities. The League serves its members through advocacy, education and training, legislative policy development, risk management, and other services.

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Report Highlights

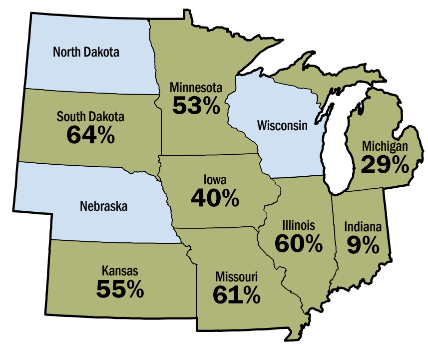
The *State of the Cities Report 2007* describes the findings of the fourth-annual fiscal conditions survey and explores the public finance system in Minnesota, taxpayer views of major taxes, and the outlook for comprehensive tax reform. Highlights from the report are listed below.

Chapter 1: City Fiscal Conditions

Four years after the 2003 state budget crisis that brought massive state aid cuts and strict levy limits, fiscal health is improving for some, but not all, Minnesota cities. Highlights of chapter 1 include:

- Roughly half of Minnesota cities saw their fiscal conditions improve in 2006, and were better able to meet their financial needs in 2006 than in 2005.
- Half of cities are concerned about the future and predict it will be more difficult to meet their financial needs in 2007 than in 2006. Larger cities are more likely to be pessimistic about their future fiscal conditions.
- The cost of wages and salaries, infrastructure needs, and the cost of employee health benefits were among the budget pressures increasing for cities in 2006.
- More than half of Minnesota cities reported an increase in the cost of employee pensions.
- Cities in the North-Central area of the United States overall show a similar pattern to Minnesota cities for 2006 (see Map RH-A). About half are optimistic about their financial circumstances in 2007.
- Minnesota cities most frequently saw shortfalls in 2006 property tax, fee, and state revenues. Reports of state revenue shortfalls peaked at 82 percent of cities in 2003 following the state aid cuts, and fell to 31 percent of cities in 2006. The incidence of fee and charges shortfalls has increased steadily since 2003.
- Cities in other states within the North-Central area rely more heavily on the sales tax than do Minnesota cities. Just over one fifth of the cities in the region overall reported sales tax shortfalls, while only 3 percent of cities in Minnesota did so.
- Budget-balancing actions most frequently used by cities across Minnesota during 2006 included revenue increases (fees and property taxes), new efficiencies, and using reserves. Cuts to spending, workforce size, and service levels overall were all less common in 2006 than in 2003.

Map RH-A: Share of cities in north-central states reporting improving fiscal conditions in 2006



Chapter 2: Taxes, Tax Reform, and the Public

Minnesota's public finance system is poorly aligned with economic and demographic trends and is in need of reform. Tax reform always involves tradeoffs among important goals like fairness and simplicity. Reform will not be successful and long-lasting without the participation of an engaged public. Highlights of chapter 2 include:

- In order for taxes and, by extension, government to be considered legitimate by the public, they must be fair. From the public's perspective, however, tax fairness is elusive because of the maze of relationships between the federal, state, and local governments; growing mistrust in government; and economic insecurity.

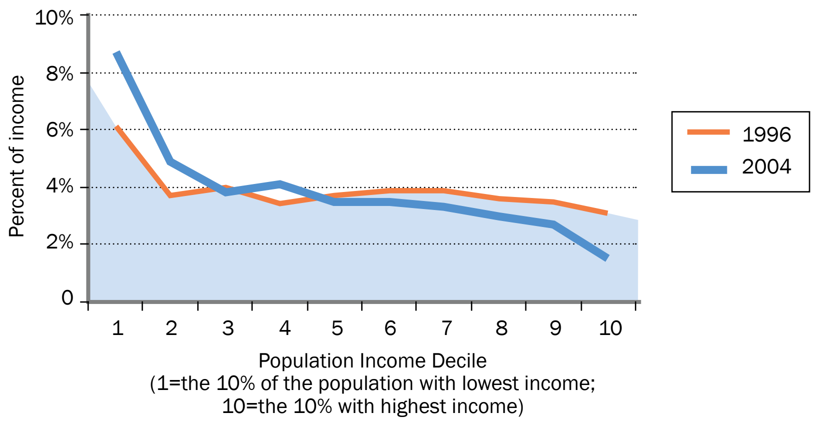
- Citizen disengagement has been fueled by the rise of the customer model of government, in which the relationship between government and citizens is characterized as arms-length transactions rather than shared governance. This relationship undermines the legitimacy of public goods, makes long-term investments more challenging, and raises expectations that any new revenues will have immediate, direct benefit to the individual.
- Citizen disengagement has also been a factor in the proliferation of tax and expenditure limits (TELs) in other states, such as California's Proposition 13 and Colorado's Taxpayer Bills of Rights. In recent years, the passage of TELs has slowed and in several states new taxes have been enacted or are under consideration.
- Forty percent of Minnesotans are dissatisfied with the amount of taxes they pay (Department of Revenue study). Minnesotans consider the sales tax to be more understandable, fair, and predictable than the property tax and the income tax.
- In a 2006 Citizens League poll "controlling taxes" was listed as the most important or second most important issue facing the state by 42 percent of respondents, more than any other issue. Of those who selected controlling taxes, 67 percent think it is most important to control property taxes.

Table RH-A. Minnesota taxpayers' views on major taxes

	Property tax	Sales tax	Income tax
Most predictable	23%	56%	18%
Most understandable	21%	55%	17%
Most fair	15%	52%	22%

- Minnesota's tax ranking is declining. While Minnesota has been a high-tax/high-service state for many decades, its relative ranking has declined from fifth in state and local taxes per $1,000 of income in 1997 to 16th in 2004. But taxes account for just over half of government revenues; other states rely more heavily on non-tax revenues than Minnesota. In 2004 Minnesota ranked 28th in total spending per $1,000 of personal income.
- Minnesota's tax system is becoming more regressive. Over the last 20 years, the regressivity of Minnesota's overall tax system has fluctuated due in part to legislative changes to the sales tax, the property tax refund credit programs, and income tax rates. The system has become marginally more regressive in recent years, and is projected to continue in that direction. The property tax, in particular, has become more regressive.

Chart RH-A. Property tax incidence 1996 and 2004



- Economic and demographic trends—namely the narrowing of the sales tax base, the growing volatility of the corporate franchise tax, increasing globalization, and the aging of the Baby Boomers—are raising serious questions about the future viability of the public finance system.
- Fundamental changes to Minnesota's public finance system seem inevitable and cities are calling for change with the LMC Financing Local Government Task Force's report, *Renew the Partnership: A Principled Approach to Financing City Government*. Among other things, the report called for increased stability in state revenues, adequate revenue sharing, an end to levy limits, and an improved state-local relationship.
- Authentic engagement on tax reform between citizens and city and other government officials will increase the chances that reform ideas will both meet the needs of our changing state and have broad enough political support to become law. Many cities are already trying new ways of connecting with citizens. As local leaders and policy-makers, city officials are in a unique position to facilitate authentic engagement and strengthen our state and local finance system into the future.

Chapter 1: City Fiscal Conditions

Introduction

The 2007 fiscal conditions survey marks the fourth consecutive year the League of Minnesota Cities has asked member cities to report on their overall financial circumstances, how a wide range of fiscal pressures impacted their budgets, and the budget actions they have taken (see the 2007 survey tool in the appendix). For the third year, several other state leagues also sent the survey to their member municipalities, allowing for comparisons between cities of different states. The 11 other state participants this year were: Florida, Georgia, Illinois, Iowa, Kansas, Michigan, Missouri, Pennsylvania, South Dakota, Tennessee, and West Virginia. Overall, the response rate to the survey was 32 percent (response rates for all participating states are found in the appendix). 421 Minnesota cities returned the survey to the League for a state response rate of 51 percent.

The fiscal conditions survey asks city officials to indicate whether they are better or less able to meet financial needs in the current year than in the previous year, and to predict whether they will be better or less able to meet those needs in the future. It does not ask how well cities are able to meet needs in any given year. The measure of "better" or "less able" is therefore a relative comparison only[1].

For second consecutive year, Minnesota cities are almost evenly split between those reporting increased ability to meet needs and those reporting decreased ability

The share of Minnesota cities better able to meet their financial needs increased from 45 percent in 2005 to 53 percent in 2006. This was also an improvement over the share of cities that predicted they would be in better shape in 2006 (46 percent). Table 1A shows the share of Minnesota cities seeing improving fiscal circumstances over the last several years.

Table 1A: Share of Minnesota cities better able to meet financial needs

2003	12%
2004	31%
2005	45%
2006	53%
2007 *(predict)*	47%

Table 1A shows that the percent of cities better able to meet needs increased significantly between 2003 and 2005 but then levels off, with Minnesota cities roughly split between those that are seeing financial circumstances improve and those that see more challenges ahead.

While it is good news that the fiscal conditions of half of Minnesota's cities are improving according to the "better/less-able measure," half the cities in the state are experiencing worsening financial circumstances.

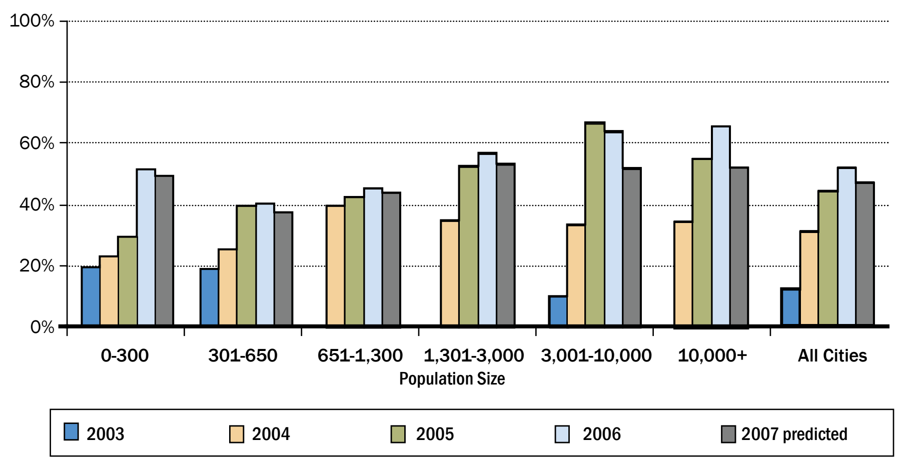
Despite more time having passed after the state aid cuts of 2003 and the economic recession of 2001-02, cities may still be feeling the effects of those events. Uncertainty about state revenues including local government aid (LGA) and the market value homestead credit (MVHC) reimbursement continues among cities. With the increase in market values over the last few years and the phase-out of the Limited Market Value program, city officials are also concerned that the tax burden is increasingly shifting onto homeowners. Cities across the state are feeling budget pressure from rising cost factors like fuel and healthcare benefits for employees. Further, there are some rumblings about another recession, especially given the concern over the recent marked decline in the housing market.

Reports of improving fiscal conditions more common among larger Minnesota cities through 2006

Having four years' worth of data allows for more robust analysis of the patterns in cities' financial outlook by population size. One trend is quite clear: Between 2003 and 2006, the increase in the share of cities better able to address their financial needs is more significant for larger cities (see Chart 1A).

Consider cities under 300 population and cities over 10,000. For the smallest cities, the share better able to meet needs in 2006 is more than twice as large as the share with a positive outlook in 2003 (51 percent vs. 20 percent). For the largest cities, however, the share "better able" in 2006 is almost 20 times as large as the share in 2003 (66 percent vs. 3 percent). The increase in the proportion of cities seeing improving fiscal conditions between 2005 and 2006, on the other hand, was most pronounced for cities under 300.

Chart 1A: Percent of Minnesota cities better able to meet needs (by population size)



For cities overall, 2007 does not look quite as good. The decrease in the share predicting that their financial circumstances will improve in 2007 is most noticeable among cities over 3,000 population. For cities between 3,000 and 10,000 population, the proportion of cities with a positive outlook actually falls for 2006 and for 2007. In the two largest population categories, the proportion of cities with a positive outlook for 2007 is smaller than the shares reporting that they were better able to meet needs in both 2006 and in 2005. This pattern suggests that larger cities may be more cautious about their future budget circumstances.

The most recent population data available shows that more than 80 percent of cities over 3,000 less able to meet needs in 2006 saw population growth from 2000 to 2005. Eighty percent of cities 3,000+ predicting tougher times ahead experienced population growth between 2000 and 2005. Despite recent growth, these cities are anticipating more challenging fiscal conditions ahead. This is, perhaps due to the threat of another recession and the slowdown in growth or actual decline it could bring.

Regional differences in fiscal outlook exist

Almost 60 percent of metro cities reported they were better able to meet their financial needs in 2006 than in 2005. In greater Minnesota, 47 percent of cities experienced improved financial conditions in 2006. When predicting what their fiscal conditions would be in 2007, 54 percent of metro cities and 42 percent of greater Minnesota cities were optimistic their circumstances would improve.

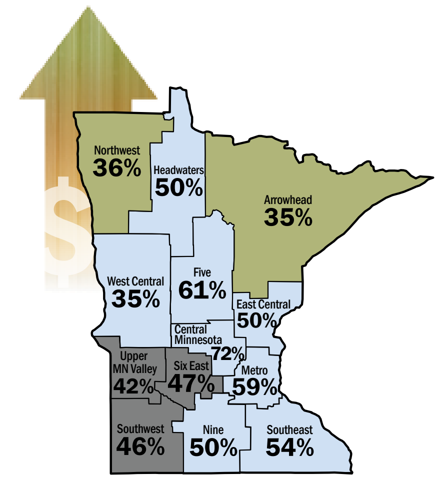
While overall roughly half of Minnesota cities experienced better fiscal conditions in 2006 than in 2005, there are some areas of the state where this pattern is not evident (see Maps 1A and 1B). Only about a third of the cities in the Arrowhead and Northwest regions, and 42 percent of cities in the upper Minnesota Valley reported they were better able to meet their financial needs in 2006 than in 2005.

On the whole, cities in Minnesota are slightly less optimistic about 2007. The share of cities with a positive outlook on their ability to meet needs in 2007 drops most noticeably in the northwest, the far southeast, and the central part of the state. This trend is most pronounced the Headwaters region and in the Central Minnesota region. In the Headwaters region, while 50 percent of cities said they were better able to meet needs in 2006, only 20 percent are predicting better circumstances in 2007. Similarly, the Central Minnesota region shows a decrease in the proportion of cities with a positive view of their fiscal conditions from 72 percent of cities to 45 percent of cities. There does not seem to be a clear relationship between population growth and ability to meet financial needs in these regions. Almost two-thirds of the cities in the Headwaters region saw population decreases between 2000 and 2005, while about three-fourths of Central Minnesota region cities had population growth over the same time period.

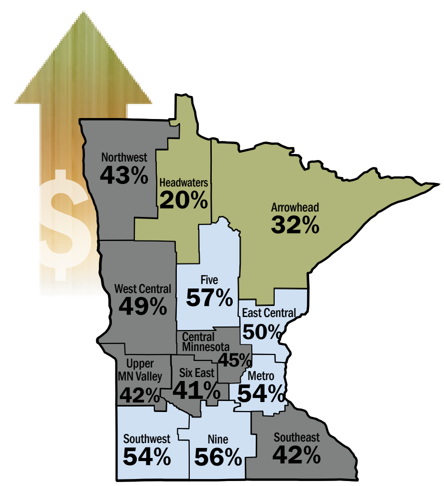
Minnesota city fiscal conditions in line with cities in other north-central U.S. states. This report compares the fiscal conditions of Minnesota cities with that of cities in other north-central states—Illinois, Iowa, Kansas, Michigan, Missouri, and South Dakota. The Indiana League surveyed its members separately, and results for Indiana cities are included in the discussion that follows where questions were identical to those on the LMC survey.

Overall, about half the cities in the participating north-central states were better able to meet their financial needs in 2006 than in 2005 (see Map 1C). Looking ahead to 2007, 48 percent of cities had a positive outlook. This is a very similar pattern to that for Minnesota cities.

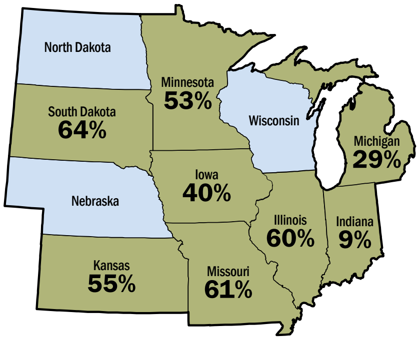
Map 1A: Percentage of cities better able to meet financial needs in 2006



Map 1B: Percentage of cities better able to meet financial needs in 2007



Map 1C: Share of cities in north-central states reporting improving fiscal conditions



As Map 1C shows, four of the other states—Illinois, Kansas, Missouri, and South Dakota—had larger proportions of cities facing favorable financial circumstances in 2006 and in 2007 than did Minnesota. In each of the eight states, the share of cities optimistic about their financial situations in 2007 is smaller than the share that saw improving conditions in 2006. Much like for Minnesota cities, concerns about the possibility of another recession and the national slowdown in the housing market are creating uncertainty.

Property tax, state revenue, and fee shortfalls most common among cities

Cities in Minnesota were most likely to identify 2006 revenue shortfalls (i.e., actual revenues were lower than expected revenues) in three areas: property taxes, state revenues, and fees and charges. Table 1B shows that these are the same revenue sources for which cities' actual amounts came up short of expected amounts most often in the previous three years as well.

Table 1B: Percent of Minnesota cities reporting revenue shortfalls*

	Property Taxes	Fees and Charges	Sales Tax	Lodging and Restaurant Taxes	State Revenues	Federal Revenues
2003	28%	17%	3%	5%	82%	12%
2004	27%	24%	1%	3%	55%	8%
2005	40%	25%	3%	4%	39%	12%
2006	40%	33%	4%	4%	31%	13%

*(*combines shortfalls of greater than and less than 10% of expected revenues)*

The share of cities experiencing property tax shortfalls in 2006 was unchanged from 2005 (40 percent). For 9 percent of cities, 2006 property tax shortfalls exceeded 10 percent of expected revenues. Cuts to the MVHC reimbursement, property revaluations, and tax settlements could have been reported as property tax shortfalls. Shortfalls in state revenues were likely due to the MVHC reimbursement cuts and decreases in LGA from the previous year, although the latter is not technically a cut. A little less than one-third of cities had shortfalls in state revenues. This is down significantly from a peak of 82 percent of cities in 2003, the year of the state aid cuts. Still, for 12 percent of cities shortfalls in state revenues were more than 10 percent of expected state dollars. Federal revenue shortfalls were slightly more common in 2006 than in the previous three years.

Fees and charges is the only revenue stream in which the proportion of cities reporting shortfalls has grown steadily each year since 2003 when 17 percent of cities experienced them. Most recently, one-third of cities indicated they experienced lower fees and charges revenues than expected. Since 2003, cities have increased their reliance on fees and charges as one mechanism to cope with cuts in state aid. Some fees and charges, such as building permits, are more susceptible to shifts in the economy and development trends—making fee revenue more difficult to budget accurately. More than half the cities reporting fee shortfalls in 2006 saw population growth from 2000 to 2005. Budgeting for building permit and other development-related fee revenues based on past growth trends may have led to reported shortfalls in cities where the pace of development has slowed down.

Cities in other north-central states had similar pattern of revenue shortfalls. Shortfalls in property tax, fees and charges, and state revenue were most common among cities in the North-Central area overall. In each of the states, at least one in five cities had a property tax shortfall in 2006. Property tax revenues came up short for roughly half the cities in Indiana and for one-third of the cities in Kansas and South Dakota. More than half the cities in Indiana and Michigan experienced shortfalls in state revenue during 2006.

Minnesota cities reported shortfalls in property tax revenue and in fee revenue more often than did North-Central cities as a group (40 percent vs. 31 percent and 33 percent vs. 30 percent, respectively). They were slightly less likely to have shortfalls in state revenues (31 percent vs. 36 percent). Overall, 22 percent of cities in the North-Central area experienced sales tax shortfalls while only 3 percent of Minnesota cities did so. The local sales tax is not a major revenue source for most Minnesota cities, while in other states cities are much more reliant on it. In Missouri for example, the average city gets just over half its revenue from the sales tax.

Table 1C: Percent of cities reporting revenue shortfalls—Minnesota vs. North-Central area

	Property tax shortfall	Fee shortfall	State revenue shortfall	Sales tax shortfall
Minnesota	40%	33%	31%	3%
North-Central area states	31%	30%	36%	22%

Cities have seen change in a variety of budget factors

Over the past year, Minnesota cities saw both positive and negative changes in a wide range of budget factors, including different kinds of mandates, the various costs associated with employees, and service needs in several areas. Of the five most frequently reported increasing factors, four cause fiscal pressure for cities. These were: prices/cost-of-living/inflation (81 percent of cities), cost of wages and salaries (80 percent), infrastructure needs (66 percent), and the cost of employee health benefits (63 percent). On the positive side, 73 percent of cities reported an increase in the value of the city tax base. Cities reported decreases most often in the following factors: the health of the local economy (23 percent of cities), population size (14 percent), and federal aid (13 percent).

While it wasn't one of the top five most frequently reported changes, the share of cities seeing increasing costs for employee pensions went from 43 percent in 2005 to 56 percent in 2006, the biggest one-year change of all budget factors listed on the survey.

The public sector overall has more older workers than does the private sector. Governments, including cities, will be among the first to experience Baby Boomers retiring in large numbers. In the next few years, the Baby Boomer generation will start to retire. According to Public Employee Retirement Association (PERA) data for Minnesota cities, almost 37 percent of city employees are over age 50 (excluding firefighters and police). For almost half of the cities in the state, at least 25 percent of workers are over age 50. In 150 cities, at least half the employees are older than 50.

In recent years, the contribution rates for cities into public pension funds have increased. The higher contribution rate is due to an unfunded liability for public employee pension benefits. Table 1D shows that almost one in five Minnesota cities have had retirements of top administrative officials or expect them in the near future. Retirements of senior staff members have occurred or are expected soon in fire departments (16 percent of cities), streets departments (16 percent of cities), and police departments (16 percent of cities).

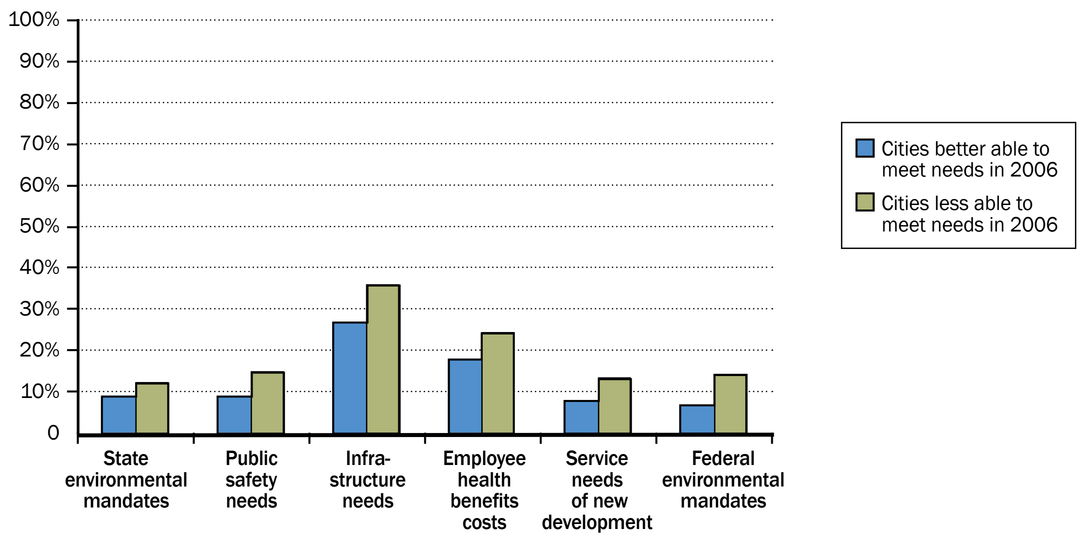
Table 1D: Cities reporting recent and expected retirements of city employees

City department	% of cities reporting recent or expected retirements
Administration	17%
Police	16%
Fire	16%
Streets	16%
Water	14%
Parks	6%

Changes in budget factors have varying impacts on cities. More than 70 percent of cities reported that increases in prices and wages for employees had at least a moderate impact on their budgets during 2006. Roughly 60 percent of cities with increasing infrastructure needs and costs for employee health benefits during 2006 experienced moderate or major budget impact. In fact, for nearly one-third of Minnesota cities, growing infrastructure needs had a major impact on their budget last year. Half of cities saw at least a moderate budget impact of increases in the public safety needs in their communities. On the upside, half of cities across the state experienced at least a moderate impact from an increase in the value of the city tax base.

The impacts from various budget factors influence a city's overall fiscal condition. Specifically, cities experiencing major impact from changes in budget factors like public safety needs, state mandates, and service needs of new growth reported worsening financial conditions more often than did cities less likely to report major budget impacts. Chart 1B shows the factors on which cities facing favorable fiscal conditions differ most from those facing worsening conditions in terms of budget impacts in 2006.

Chart 1B: Cities reporting more major impacts from budget factors were less able to meet needs



Other states. For cities in the North-Central area overall, the following five budget factors were most often identified as having increased between 2005 and 2006: on the negative side, prices/inflation (80 percent of cities), cost of wages and salaries (79 percent), infrastructure needs (64 percent), cost of employee health benefits (62 percent), and on the positive side, value of city tax base (61 percent). These were the same five factors most often cited as increasing over the last year by Minnesota cities. In the North-Central area, 23 percent of cities reported a decrease in the health of the local economy. Decreases in population size and in federal aid were reported by 13 percent and 12 percent of cities, respectively. Again, these were the same decreasing factors most often reported by cities in Minnesota.

Rate of revenue increase holds steady; other budget strategies less frequently pursued

Cities across Minnesota continue to use a variety of strategies to deal with their fiscal circumstances. Table 1E shows the trends in six, broad budget-balancing strategy categories over the last four years. The first three of these categories group together several discrete budget actions. Revenue increases include property tax increases and increases in fees. The spending decreases category includes cuts in infrastructure, public safety, and other spending, as well as reductions in the overall growth rate of spending. Efficiency measures are increases to productivity, contracting out or privatizing, and increasing inter-local agreements.

Table 1E: Budget-balancing actions taken by Minnesota cities, 2003-2006

	Revenue increases	Spending decreases	Increase efficiencies	Workforce cuts	Service cuts	Draw down reserves
Actions in 2003	85%	55%	33%	26%	20%	60%
Actions in 2004	84%	47%	34%	22%	15%	46%
Actions in 2005	83%	12%	32%	5%	9%	33%
Actions in 2006	83%	11%	31%	5%	3%	31%

The share of cities implementing revenue increases via property tax and/or fee and charges increases has remained virtually unchanged since 2003. Three-quarters of cities increased taxes in 2006 and about 40 percent raised fees and charges. Spending decreases, workforce cuts, and service cuts have all decreased in frequency between 2003-2006. Cities employed strategies in these three categories much more often in 2003 and 2004, immediately following the large state aid cuts.

While more than half of cities cut spending in 2003, only 11 percent indicated they did so in 2006. In fact, at least half of cities increased spending on infrastructure and public safety for 2007. Similarly, a quarter of cities reduced the size of their workforce in 2003, but in 2006 only 5 percent indicated they took that action and 18 percent of cities actually added to their workforce. Very few cities made cuts to overall service levels in 2006 (3 percent). Cities continue to seek ways to operate more efficiently (31 percent), including collaborating with other entities. In 2006, 14 percent of cities increased the number and/or scope of cooperative agreements.

Cities in other north-central states raising taxes, drawing on reserves, and increasing fees. Overall, the most common budget-balancing actions taken by cities in the north-central states were raising taxes; increasing reliance on reserves; and increasing fees, charges, and license fees. The least common actions were cutting public-safety spending, cutting the growth rate of operating spending, and reducing the size of the workforce.

Almost half the cities in the North-Central area overall increased taxes in 2006. Minnesota cities were most likely to raise taxes, followed by cities in Indiana and South Dakota. While only 34 percent of cities overall increased fees and charges, almost half of Michigan's cities took this action in 2006. In Minnesota, about 40 percent of cities increased fees and charges. Minnesota cities were less likely to privatize or contract out, increase the number of inter-local agreements, and make service cuts. A larger share of cities in Minnesota pursued these actions more immediately following the drastic state aid cuts of 2003.

Conclusion

For the second year, Minnesota cities are almost evenly split between those that are seeing fiscal conditions improve and those that are seeing worsening financial circumstances. Cities are also about evenly divided when looking ahead to 2007 into those with a positive outlook and those with less optimism. Overall, cities in the North-Central area of the United States echo the Minnesota trend and are nearly split into those facing improving conditions and those seeing more trouble ahead. That about half of Minnesota's cities are experiencing improving fiscal conditions is good news. On the other hand, it is a worrisome trend that half the cities are facing more difficult times.

A wide range of factors affects city budgets, many of which are beyond the control of city policymakers like inflation and state and federal mandates. Some factors that had major impacts on city budgets over the last year include infrastructure needs, the cost of health benefits for city employees, public-safety needs, and the service needs of new development.

Cities continued to employ different budget balancing actions in 2006, including revenue increases like fee increases and new efficiencies such as cooperative agreements with other cities. Cities in other North-Central area states used similar strategies to deal with their financial challenges.

Chapter 2: Taxes, Tax Reform, and the Public

Introduction

Minnesota's public finance system is in trouble. The state and local revenue systems are still largely based on a 19th century agrarian economy. Traditional cooperative relationships between federal, state, and local governments are fraying. The federal debt now exceeds $26,000 for every U.S. resident (www.ConcordCoalition.org). Globalization, economic trends, and the aging of our population will further challenge the system by increasing costs for current governmental programs and simultaneously eroding existing tax bases.

"Taxes are what we pay for civilized society."

— Oliver Wendell Holmes, Jr.,
U.S. Supreme Court Justice

This is not late-breaking news. The League's Financing Local Government Task Force faced many of these issues head-on in its 2005 report, *Renew the Partnership: A principled approach to financing city government.* There is growing recognition among state and local officials and the public that fundamental change to the system is inevitable. There are calls at the state Capitol for a comprehensive tax reform commission. There are also more modest proposals for studies on important pieces of the system like LGA and Truth-in-Taxation.

Improving the public finance system is critical. But perhaps equally important is improving the relationships government at all levels has with citizens and taxpayers. Fundamental reforms are unlikely to be achieved without widespread, meaningful participation by citizens in governance. As government leaders most visible and accessible to citizens, city officials have a critical role in shaping the reform agenda to ensure long-term fiscal health for Minnesota's communities, and thereby the strength of the state. City officials are also well positioned to lead the way on re-engaging citizens, both in tax reform and other public policy issues.

The first chapter of this report verified that the current system is failing many cities: 43 percent of Minnesota's cities report worsening fiscal health from 2005 to 2006, and almost half were pessimistic about 2007. This chapter will set the stage for city officials and citizens to help shape the tax and governance reform discussions that will likely occur over the next several years by considering:

1. The relationship between taxpayers and government.
2. Minnesota taxpayers' perspectives.
3. Recent trends in Minnesota's state and local finance system.
4. The misalignment of the system with economic and demographic trends.
5. How all this sets the stage for tax reform.

The relationship between taxpayers and government

Taxes have never been popular. In fact, the "tax revolt" of the Boston Tea Party was a catalyst for our nation's independence. If taxes, and by extension government, are to be considered legitimate by the public, they must be viewed as reasonably fair.

For tax policy-makers, tax fairness can be framed as trying to find the fair price for public goods based on the benefits received and taxpayers' ability to pay.[2] The system as a whole can be judged on general tax principles such as understandability, horizontal and vertical equity, competitiveness, reliability and efficiency.[3]

But for most citizens and taxpayers, the yardstick is somewhat different. The myriad of taxes and fees paid to the federal, state, and local governments can be confusing and unpredictable. It is difficult to know what taxes are paying for, as many public goods like public safety and environmental protection only indirectly benefit individuals. In a 2006 poll of Minnesotans sponsored by the Citizens League, 81 percent agreed they would feel better about paying taxes if it were clearer to them how the money is being spent.[4]

Tax fairness may be more elusive today than ever before:

- Our federalist system has evolved through mandates, intergovernmental transfers, contracting out, and inter-local agreements into a maze of relationships and responsibilities that can confound elected officials and average citizens alike.
- Public trust in government is on a decades-long downward slide.
- Globalization and demographic changes are undermining tax systems.
- Our nation is incredibly wealthy, but unaffordable health care, shakeups in traditional manufacturing industries, and income and educational disparities mean economic security is elusive for many. Economic insecurity fosters heightened concern about taxes.

Citizens' relationship to government: Customers? Many government reformers in the past 15 years have pushed for government to behave more like competitive private industry, and less like a monopolistic bureaucracy. This management model has led to efficiencies in government service delivery (e.g., improved service through state departments of motor vehicles). Many of these reformers have also advocated for defining those who interact with government as "customers" and referring to those interactions as "transactions."

This model has been successful in using competitive market forces to improve governmental performance, especially where there is a fee for a service of direct benefit to the individual.

But it also encourages a customer perspective on taxes and government spending—what an individual pays in taxes should be directly proportional to one's direct, short-term benefit from government spending. This customer perspective undermines the legitimacy of public goods of general benefit and makes long-term investments, especially in human capital, more difficult. It creates an expectation that any new public revenues will have an immediate corresponding direct benefit.

The customer model also has reinforced a separation between citizens and government. Citizens as customers view government as "them," a bureaucracy that exists to serve the customers and provide them with services tailored to their needs. In this model, government officials view citizens as "them," a group of consumers to be polled and put into focus groups.

Undermined in these transactions is the idea of governance—citizens and officials working together on a shared destiny and investment in common goals like public safety, public health, education, and preservation of the environment.

"Taxation equals slavery"

— slogan on t-shirt from Advocates for Self Government

Strengthening democratic governance. Good governance obliges citizens to play an active role in shaping the direction of government. It also often requires government officials to rethink their role—to open up processes and share decision-making with citizens. It demands that both citizens and government officials engage in authentic and mutually-respectful dialogue, recognizing the complex and difficult tradeoffs inherent in good public policy-making. City officials from around the country have been grappling with this fundamental shift in how citizens and government work together. The National League of Cities' Strengthening Democratic Governance project highlights several principles[5] to guide this engagement:

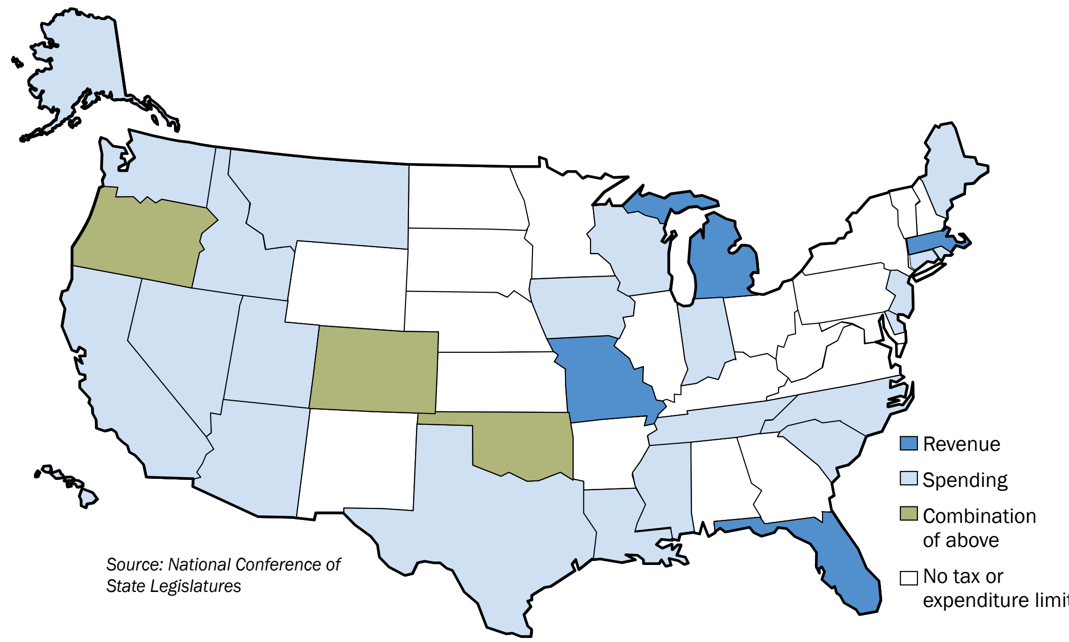
- Reaching out through a wide array of groups and organizations is critical for mobilizing large numbers of citizens, and many different kinds of people.
- Most public problems cannot be solved without the effort, energy, and ideas of citizens and their organizations (including churches, associations, businesses, and nonprofit groups).
- In face-to-face dialogue, people can be expected to learn, empathize with people with different views and backgrounds, and change their own opinions.
- Large-scale, open-minded deliberation, where citizens consider a range of policy options, results in public decisions that are fairer, more informed, and more broadly supported.
- Giving people a sense of "political legitimacy"—a sense of status and membership in their community—promotes individual responsibility and leadership.
- When people have a range of reasons to participate, they are more likely to stay involved.

Legislative bodies generally fall short of the ideals of these principles. They often have to make policy decisions without a clear understanding of public opinion. Still, in the long-run elected officials and tax policy generally respond to citizen demands for change. Most changes in tax law are incremental responses to particular complaints (e.g., indexing income tax brackets to reduce "bracket creep"). Occasionally, more comprehensive reforms are enacted (e.g., Minnesota's 2001 Big Plan property tax reform). Sometimes, when dissatisfaction flares and legislative solutions are elusive, tax and expenditure limits are enacted.

Tax and expenditure limits. Tax and expenditure limits (TELs) are broad, statewide fiscal policies that attempt to control taxes and spending. Put most favorably, TELs provide taxpayers with predictable limits on governmental taxing and/or spending. Less charitably, TELs can be an indication that voters (or legislators themselves) don't approve of past legislative decisions and don't trust legislators to make the right decisions in the future. They may be promoted by advocates of a limited-government philosophy. TELs that limit local governments can be ways for voters or legislators from one part of a state to enforce fiscal restraint on other parts of the state. Once enacted, they can force budget reprioritization and thwart new initiatives, even those with public support.

The most famous TELs are California's Proposition 13 and Colorado's Taxpayer Bill of Rights (TaBOR). As of 2005, 30 states had some form of tax or expenditure limits (see Map 2A). They are more common in states that have initiative processes, where voters can enact TELs without legislative approval. Many were enacted in the late 1970s and early 1990s, at times of economic uncertainty. In the early 2000s there was speculation that a round of new or expanded TELs would be enacted, but only two states have passed new TELs in recent years. Many other proposals were rejected at the ballot box, by legislatures, or by the courts. Colorado voters, convinced that the restrictions were hurting their quality of life, temporarily relaxed the TaBOR provisions in 2006.

Map 2A: States with some form of tax or expenditure limits (2006)



Source: National Conference of State Legislatures

Minnesota has never had a statewide TEL, and voters have rejected enacting the initiative process three times, in 1913, 1915, and 1980. The Minnesota Legislature has imposed property tax levy limits on counties and cities over 2,500 population in 27 of 33 years from 1972 to 2004. But in recent years the Legislature has allowed local elected officials to decide the appropriate level of taxation in their communities. Minnesota's unique Truth-in-Taxation process attempts to replace arbitrary caps with taxpayer involvement by providing projections of future property tax bills to taxpayers and requiring multiple forums for public input during the budget-setting process.

Today, the TEL movement seems to have cooled, at least temporarily. In fact, the combination of broad tax cuts in the late 1990s, huge budget shortfalls after the 2001 recession, and growing service demands have sparked tax increases in many states. According to the National Conference of State Legislatures, states enacted in aggregate at least a billion dollars in tax increases every year since the recession. Tobacco and sales taxes accounted for the bulk of tax increases while income and business tax cuts have been common.[6] In general, state tax systems are moving away from progressive income taxes toward regressive consumption taxes and fees.

"Taxation with representation ain't so hot either."

— Gerald Barzan, humorist

Minnesota taxpayers' perspectives

Minnesota has been a high-tax/high-service state for many decades, although Minnesota's relative ranking has declined in recent years (more on this later). While Minnesota's relative rank has dropped, Minnesotans have decidedly mixed perceptions about our state and local tax system. A 2005 Department of Revenue survey[7] found:

- Roughly equal shares of Minnesota residents are satisfied or dissatisfied with the fairness of Minnesota's overall tax system based on ability to pay (40 percent and 38 percent, respectively);
- However, more residents are dissatisfied (40 percent) than satisfied (33 percent) with the amount of taxes they pay;
- Residents who feel Minnesotans enjoy a higher quality of life than residents of other states are more likely to be satisfied with the amount of taxes they pay;
- Only 26 percent are satisfied with the overall system based on the extent to which taxpayers are treated equally, while 52 percent are dissatisfied.

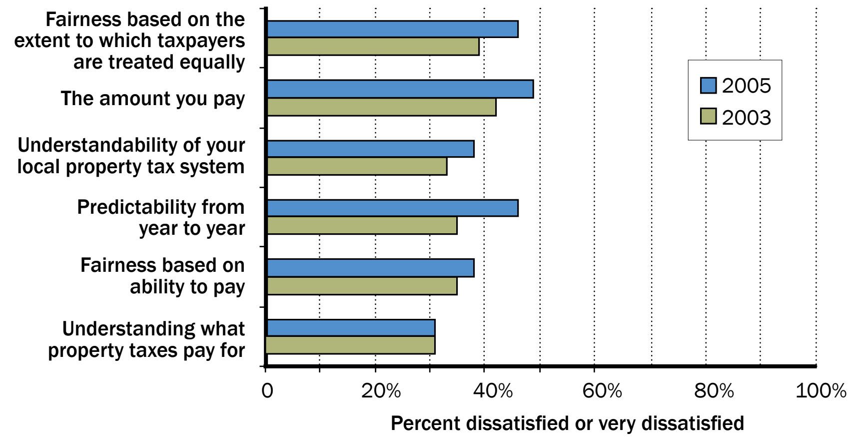
Among the three major taxes, the sales tax is by far considered the most predictable, understandable, and fair. The income tax (the state's largest source of revenue) and the property tax (Minnesota cities' main source of revenue) are viewed much less favorably (see Table 2A).

Table 2A: Minnesota taxpayers' views on major taxes

	Property tax	Sales tax	Income tax
Most predictable	23%	56%	18%
Most understandable	21%	55%	17%
Most fair	15%	52%	22%

Dissatisfaction with the property tax is nothing new. But the level of dissatisfaction in almost every aspect of the property tax system is growing. Almost half of Minnesotans expressed dissatisfaction in 2005 with the amount of property taxes they paid, up from 42 percent in 2003. Forty-six percent are dissatisfied with the predictability of property taxes, up from 35 percent in 2003 (see Chart 2A on next page) Dissatisfaction is similarly growing toward the income tax, but not toward the sales tax.

Chart 2A: Minnesotans' dissatisfaction with the property tax system



In the 2006 Citizens League poll, "controlling taxes" was listed as the most important or second most important issue facing the state by 42 percent of respondents. "Controlling taxes" out-polled all other options including "access to affordable health care" (40 percent), "creating jobs and a healthy economy" (30 percent) and "improving the quality of education" (29 percent). Of those who selected controlling taxes, 67 percent think it is most important to control property taxes.[8]

While property taxes have been increasing faster than inflation, Minnesotans still pay less in property taxes than most Americans. As of 2004, Minnesota ranked 37th in property tax collections per $1,000 of income.[9]

Recent trends in Minnesota's state and local finance system

How Minnesotans pay for government continues to evolve. Business cycles and other economic and demographic trends impact how much money taxes and fees raise and who ultimately pays them. Legislation is often enacted in response to these trends, although frequently the legislation has unintended consequences or is reacting to a trend that has already peaked or even reversed itself.

Minnesota's tax ranking and price of government is declining. In 2005, 68 percent of Minnesota residents believed they pay more income, sales and property taxes than residents in most other states.[10] This is an accurate perception, since the question applies only to taxes. According to the Minnesota Taxpayers Association, in 2004 Minnesota ranked 10th in state and local taxes per capita, and 16th in state and local taxes per $1,000 of personal income.[11]

But taxes account for just over half of government revenues; other states rely more heavily on non-tax revenues than Minnesota. Minnesota ranked 28th in total spending per $1,000 of personal income. Minnesota's system relies more heavily on state taxes and less heavily on local taxes than the average state. As of 2004, Minnesota still ranked in the top five for state income tax collections per capita.

"Government is a contrivance of human wisdom to provide for human wants. People have the right to expect that these wants will be provided for by this wisdom."

— Jimmy Carter, U.S. President

Table 2B: Minnesota tax and expenditure rankings 1997 and 2004

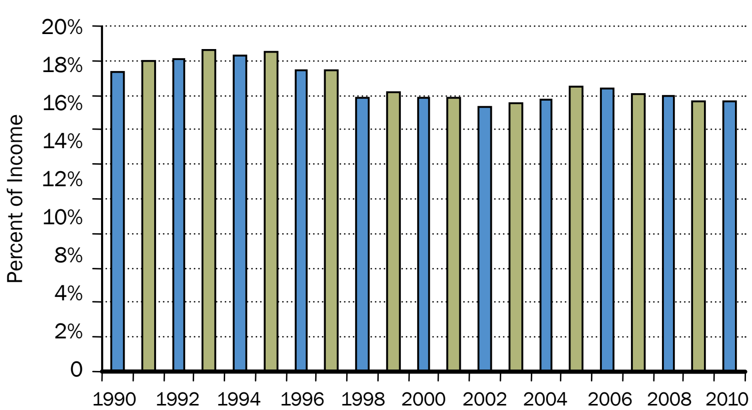
	1997 Rank	2004 Rank
State and local taxes per capita	6th	10th
State and local taxes per $1,000 of income	5th	16th
State and local expenditures per $1,000 of income	19th	28th

Source: Minnesota Taxpayers Association. Note: Includes Washington, D.C.

Other groups have measured Minnesota's rank even lower. An editorial in the *Minneapolis Star Tribune* cites analysis of U.S. Census data by a labor organization that puts Minnesota 36th in 2004 in state and local revenues as a share of personal income, down from ninth in 1992.[12]

According to the state's annual price of government reports, Minnesota state and local governments collected 55 percent more dollars in 2006 than they did in 1996. But Minnesotans' personal income has increased even more (64 percent). State and local governments collected about 16.4 cents of every dollar Minnesotans earned in 2006, down from a high of 18.6 percent in 1993 (see Table 2B). The price of government dropped most rapidly from 1995 to 2002 when personal income grew rapidly and several tax and fee cuts were enacted.[13]

Chart 2B: Minnesota's price of government (state and local taxes as percent of personal income)

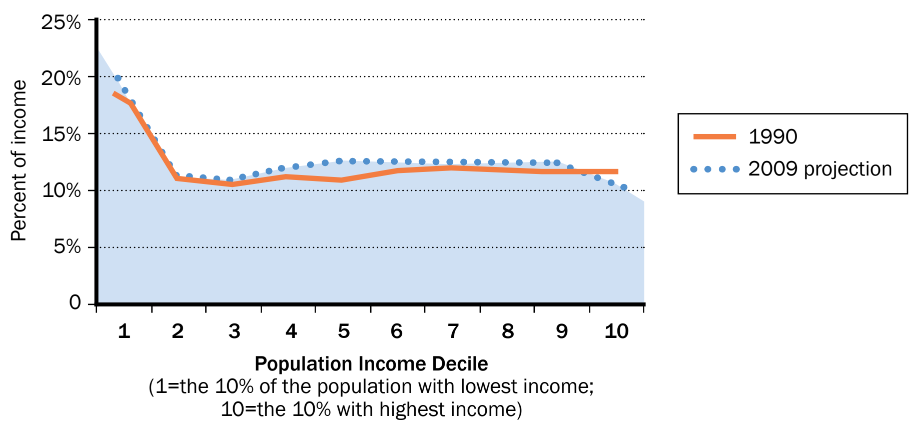


Taxes have become more regressive. One way to measure the fairness of the tax system is to look at the percent of income paid in taxes across different income levels. This is called the *incidence* of the tax system. If taxpayers at all income levels pay the same share of income, the system is considered to be a proportional system. If wealthier taxpayers pay a higher share of their income, the system is progressive. If poorer taxpayers pay a higher share of their income than wealthier households, the system is regressive.

According to a 2003 analysis by the Institute on Taxation & Economic Policy, almost all state and local tax systems in the United States are regressive overall. The income tax is generally the most progressive tax. The sales tax is a very regressive tax. Minnesota's system, which relies heavily on a progressive income tax, is still regressive overall. But it is less so than most states.[14]

In the past two decades, the overall tax system has become slightly more regressive, with middle-income taxpayers paying a higher percent of their income in state and local taxes and the richest 10 percent paying a lower share. Chart 2C shows the Department of Revenue's estimates of the percent of income paid in state and local taxes by level of income in 1990 and projected for 2009.[15] The overall regressivity has fluctuated since 1990.

Chart 2C: Total tax incidence 1990 and projected 2009



Several legislative actions have contributed to this fluctuation. The sales tax, a very regressive tax, was increased from 6 percent to 6.5 percent in 1991. Increases to the property tax refund credit programs in the 1990s decreased the regressivity. The income tax rates were reduced in both 1999 and 2000, reducing the amount of revenue raised through the income tax. Since the income tax is the only major tax that is progressive, reducing the income tax increased the regressivity of the overall system.

In addition, fees and other non-tax revenues have increased much more quickly than tax revenues. From 1990 to 2006, state and local fees and charges increased two-and-a-half times faster than tax revenues (318 percent and 125 percent, respectively). Fees are generally more regressive than taxes, so the tax incidence study, which only looks at tax revenues, likely underestimates how much more regressive the governmental finance system has become.

For example, the Department of Revenue estimates that the new health impact fee on tobacco products costs the poorest 10 percent of Minnesotans more than 1 percent of their annual income, while it costs the wealthiest 30 percent of Minnesotans less than 0.1 percent of their annual income.[16] The cap on license tab fees enacted in 2000 has increased the regressivity of that fee. Other new and increased fees, such as the increases to the state surcharge on moving violations are also regressive.

Taxes on business and regressivity. According to the tax incidence study, taxes levied against businesses are mostly passed on to customers in the form of higher prices and workers in the form of lower wages, rather than being passed on to shareholders in the form of lower profits. Because of this, business taxes generally tend to make the system more regressive. About a third of Minnesota's taxes are levied on businesses and two-thirds on individuals.

Property tax changes and regressivity. Of the three major taxes, the property tax has seen the most legislative changes in recent years. For example: the Big Plan reforms of 2001:

- Reduced class rates for business, non-homestead residential and high-valued homestead property.
- Began phasing out the limited market value program.
- Created a new state property tax on businesses and cabins.
- Reduced state aids to cities and counties.
- Eliminated the general education property tax levy and transit levies.

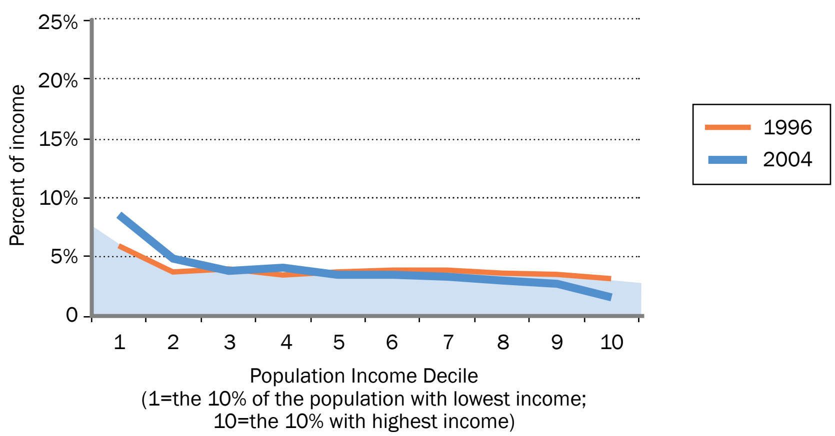
These changes, along with the class rate changes of the late 1990s, and an especially-strong housing market coupled with a weak commercial office and industrial market, all caused property tax burdens to shift from business property to residential homestead property—particularly moderate-value homestead property. From 1997 to 2007, commercial and industrial property taxes increased by 28 percent while homestead property taxes increased by 76 percent.[17] Since the 2003 state budget crisis cuts to state aids and credits, flat school funding and new mandates have helped push property tax levies to increase much faster than inflation (about 35 percent to 20 percent, respectively).

"A tax loophole is "something that benefits the other guy. If it benefits you, it is tax reform."

— Russell B. Long, U.S. Senator

These changes, along with underlying market forces, have made the property tax more regressive than in the past. Chart 2D shows estimates of percent of household income paid in property taxes by level of income in 1996 and 2004. Disregarding the richest and poorest 10 percent of Minnesota households, the property tax was close to proportional in 1996, with incidence ranging from 3.4 percent to 4.0 percent of income. By 2004 the incidence of the property tax shows a more steady decline as income increases.[18]

Chart 2D: Property tax incidence 1996 and 2004



Minnesota's tax system is misaligned for economic and demographic trends

The changes to the tax system outlined above are raising difficult issues about the fairness of our state-local revenues system. Yet other serious questions are growing in prominence because of the system's failure to change along with the profound economic and demographic trends facing our state.

The sales tax is antiquated. Tax experts recommend that taxes be structured so as to minimize their impact on people's economic decisions. In this regard, taxes with broad bases and low rates are superior to taxes with narrow bases and high rates. In other words, tax everything but only a little bit. Minnesota's sales tax measures poorly on this scale. By exempting major categories of goods such as food and clothing, Minnesota's sales tax base is among the narrowest in the nation.

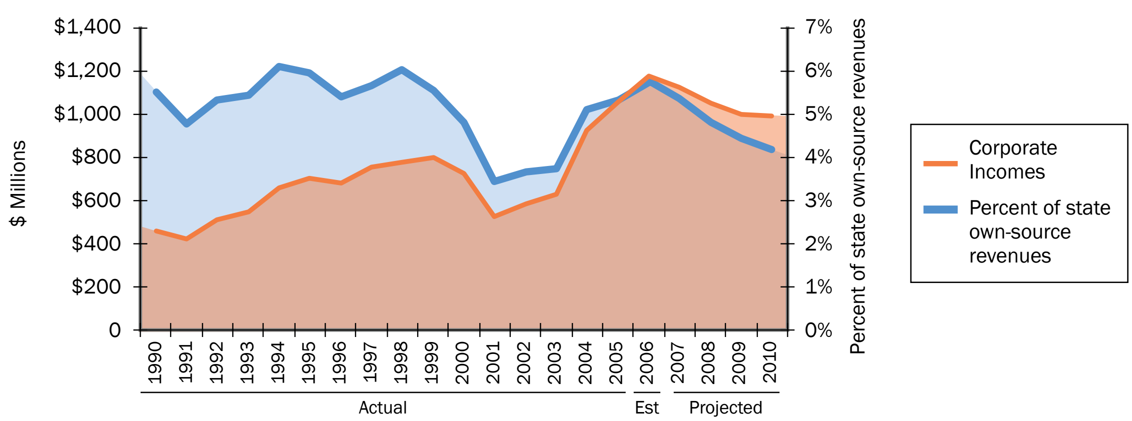
The sales tax is the state's second biggest source of revenue, raising $4.5 billion a year, accounting for one of every six dollars collected by the state. But the sales tax base is slowly eroding as much of our state's economic activity shifts from tangible goods, which are generally taxable, to services (e.g., health care, attorneys, and other professional services) that are generally tax exempt. Internet and catalogue purchases are also growing. And while these types of purchases technically require a use tax to be paid, there is currently no easy way to collect and enforce the use tax. The growing market of intangible goods like software and digital music are similarly missed by the sales tax. A group of states, including Minnesota, continues to work together through the Streamlined Sales Tax consortium to try to increase collection of taxes for online purchases (see chapter 3 of the LMC *State of the Cities Report 2004* for a broader discussion of these issues).

These trends have a big impact on the sales tax. While there have been no major new exemptions to the sales tax, sales tax revenues have declined from almost 2 percent of state gross domestic product (GDP) in 1992 to less than 1.8 percent in 2005. Had the sales tax continued to raise the same share of GDP as in 1992, receipts would be $300 to $400 million higher annually today.[19]

The corporate franchise tax is unstable. The corporate franchise tax (sometimes referred to as the corporate income tax) is among the most volatile state revenue sources; revenues are closely tied to the business cycle. It has fluctuated from between 6.1 percent of state own-source revenues in 1994 to 3.5 percent in 2003 (see Chart 2E).[20]

Globalization has made capital and jobs more mobile than ever before. Taxing corporations has consequently become more complicated. For example, Minnesota law allows special tax reductions for foreign operating corporations (FOCs) for business operations outside of the U.S. But many policy-makers are concerned corporations are using the FOC law to shelter domestic income from taxation. Some claim aggressive use of the law is reducing Minnesota corporate income taxes by as much as $100 million a year.

Chart 2E: Corporate income tax revenues



Source: Price of Government reports, Minnesota Department of Finance

The Baby Boomers are approaching retirement. The Minnesota State Demographic Center projects that the number of Minnesotans over age 65 will exceed the number of school-aged Minnesotans for the first time by 2020. The state demographer also projects much slower growth in Minnesota's workforce in the coming decades than what the state has historically experienced. As a greater share of Minnesotans move into retirement, their earning and spending patterns will change dramatically. This will likely reduce income and sales tax revenues. It will also increase demand for limits on property taxes since a greater share of households will be living on fixed incomes. State Economist Tom Stinson has estimated that the income and sales taxes paid by a typical married couple may decline by as much as 60 percent upon retirement.[21]

"The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing."

— Jean Baptiste Colbert, Controller General of Finances for Louis XIV

Health care and other spending pressures persist. The cost of health care, both for public employees and for public programs that subsidize health care for the elderly and poor, is growing at a rapid rate and squeezing federal, state, and local budgets. These and other long-term spending pressures make addressing the slow erosion of tax bases even more pressing.

How all this sets the stage for tax reform

With all these growing challenges, fundamental changes to our public finance system seem inevitable. Minnesota cities were among those sounding the call for change with the League's *Renew the Partnership* report in 2005. But tax reform always involves tradeoffs. For example:

- Making a tax more fair with an exception for a special case makes the system more complex to administer and comply with and harder to understand.
- Changing the bases or rates of a tax or moving from one type of tax to another shifts tax burdens among taxpayers.
- The public's appetite for public services always outweighs its tolerance for taxes, and those demanding services frequently aren't exactly the same group paying the taxes.
- Tax burdens impact the state's business competitiveness and attractiveness to residents.

Will change come in incremental steps or as comprehensive reform? What might such reform look like? The current debates among tax policy experts offer some clues.

State sales tax. Expanding the base of Minnesota's sales tax would make it more viable, less distorting, and more reflective of current economic trends. Gov. Ventura's 2001 Big Plan initially contained proposals to tax many services, but they were rejected by the Legislature. These issues are likely to re-emerge in any broad tax reform discussions. Minnesota and other states also need the ability to tax Internet and catalogue-based sales and sales of digital products, which likely will require federal action. Broadening the tax base to include economic necessities like food raises important equity issues for the poor, which will need to be addressed by reformers.

Corporate franchise tax. Globalization and the heightened competition it brings for businesses and jobs makes the corporate franchise tax—and business taxation more broadly—perhaps the most difficult aspect of reform. Tax burden is not the only factor in business location decisions; the quality of infrastructure, a well-educated workforce, and many other factors matter as well. But the threat of business flight to lower tax states and countries will persist.

Policy-makers have explored alternative business tax models like a broad business activities tax. But a Department of Revenue survey of corporate income taxpayers found that 84 percent did not favor replacing the corporate franchise tax with a different type of business tax.[22]

Given the regressivity of business taxes and the difficulty of uniformly applying the corporate franchise tax, some reformers like the Twin Cities-based Growth and Justice think tank suggest that perhaps eliminating the corporate franchise tax and replacing it with a more progressive personal income tax may serve both the business community and less well-off Minnesotans. The Job Opportunity Building Zones (JOBZ) program, which rewards new and expanding businesses with near-complete tax exemptions, can be characterized as a step in that direction for a subset of businesses in greater Minnesota.

Individual income tax. Minnesota's personal income tax is based on the federal income tax. This greatly simplifies filling out the state income tax form, but it also limits Minnesota's flexibility in making changes to the tax. There are several special exemptions and deductions on the state form that narrow the tax base and increase complexity.

At the federal level, attempts to reform the income tax over the years have met with limited success. Radical proposals like a simple flat-rate income tax with no deductions or replacing the income tax with a national consumption tax have come and gone. Research suggests that much of the support for these proposals has been based on the mistaken belief that they would be more progressive than the existing income tax.[23]

Most of the significant changes to the income tax in the past decade have been cuts to the tax rates and additions of new deductions and credits that narrow the tax base and add to the system's complexity.

Reform may begin with the Alternative Minimum Tax (AMT) problem. The AMT, originally intended to prevent extremely high-income individuals from avoiding federal income taxes, requires all taxpayers to calculate their tax liability using an alternative set of deductions and exemptions, and compare the result to their liability under the standard calculations. If the alternative calculation is higher, the difference is paid as AMT. Following the 2001-2006 tax cuts and in the absence of adjustments for inflation, the number of AMT taxpayers is projected to grow from about a million in 1999 to 31 million in 2010. The AMT calculations do not allow for the standard deduction or deductions for state and local taxes, hitting taxpayers with children and those in high-tax states particularly hard. Minnesota ranked 11th in the percent of income tax returns paying the AMT in 2004.[24]

State-local relationship. The Minnesota Miracle of the early 1970s established a local government finance system that relies heavily on state-collected income and sales taxes distributed to local governments to supplement local property taxes to pay for local services. The goal has been to ensure residents receive adequate services without paying inordinately different levels of property taxes, regardless of where in the state they are located.

In the *Renew the Partnership* report, city officials articulated a vision similar to the goals of the Minnesota Miracle. The report did not call for a return to the specific policies of the 1970s; many of the Minnesota Miracle policies were imperfect in their implementation—LGA formulas, for example, were continually tinkered with until 1993. But rather, the report called for creating a more accountable, reliable, flexible, fair, and adequate state-local finance system.[25]

This call was answered in a few different ways recently, namely the partial restoration of LGA funding in 2005, the forming of an informal advisory body of state and local officials to discuss intergovernmental relations issues, and the absence of levy limits for cities in the last couple of years. Several other recommendations from the report have gained some traction in debates at the state Capitol, including:

- Addressing property tax burdens by ensuring an adequate income-tested circuit breaker program.
- Stabilizing state revenue streams to minimize state budget surpluses and shortfalls.
- Exploring a metro-wide sales tax for transportation and transit.
- Restoration of the remaining LGA cuts.

Conclusion: Taxpayers, citizenship, and tax reform

Taxpayers bring complex perspectives to tax reform. Minnesotans generally prefer sales taxes to income and property taxes. This may indicate the possibility for broadening the sales tax base to make it more viable into the future. Yet sales taxes are very regressive. Minnesotans believe the property tax is the number one tax in need of control, yet Minnesota's property tax levels are much more competitive than the income tax. This may indicate preference for higher income tax levels, at least as an alternative to higher property taxes.

Minnesotans say they would feel better about paying taxes if they knew better what they were paying for.[26] And research suggests that voter education can change popular support for policies. For example, one study found that providing information on the impacts of a federal flat tax or consumption tax changed a significant share of citizens' opinions on the proposals.[27] In developing the 2001 Big Plan, the Department of Revenue conducted a citizen jury on tax reform.[28] In addition, the commissioner took pains to travel the state to have dialogues with taxpayers on tax reform and its tradeoffs. The Citizens League also has a long history of successfully engaging citizens in complex public-policy problems.

These examples demonstrated that ordinary citizens, when given good information and an opportunity to deliberate, are able to make reasoned judgments about public-policy reform and tradeoffs. The state's policymakers do not have the resources to conduct citizen juries for all taxpayers. But that experience indicates that even with a topic as unpopular as taxes, citizens can and should be engaged in meaningful debate about the need for tax reform that will meet the state's future needs.

Citizens should not be expected to pass judgment on the value of every income tax deduction and sales tax exemption. That is the role of the tax policy experts. But citizens can and should articulate in broad terms how our system should adapt to our future:

- Given our service needs, what level of taxes and fees is acceptable?
- Is our system adequately progressive?
- Are we taxing and spending in the right ways to maximize our competitiveness and quality of life?
- Does our state-local fiscal system provide for adequate local government services at a fair price throughout the state?

Authentic engagement on tax reform between citizens and city and other government officials will increase the chances that reform ideas will both meet the needs of our changing state and have broad enough political support to become law. It could also reframe the taxpayer relationship to government and rebuild some of the trust in government that has been lost in the past several decades. Many cities are already trying new ways of connecting with citizens. As local leaders and policy-makers, city officials are in a unique position to facilitate authentic engagement and strengthen our state and local finance system into the future.

Endnotes

1 Some of the year-to-year change in responses is due to the fact that a slightly different group of cities responds to the survey each year. Looking at just the cities that have responded to the survey each year echoes the trend highlighted in the table above. Among these cities, the share saying "better able" steadily increased from 2003 to 2005 and levels off in 2006 and 2007.

2 Riamondo, Henry, "Economics of State and Local Government," Praeger Publishers, 1992, pp.109-111.

3 "Model Revenue System for Minnesota," Minnesota Department of Revenue, July 1992.

4 Minnesota Anniversary Project poll, Citizens League, 2006, www.citizensleague.net.

5 "The Rise of Democratic Governance: How Local Leaders are Reshaping Politics for the 21st Century," National League of Cities, 2004, p.1.

6 National Conference of State Legislatures web site, www.ncsl.org.

7 "2005 Taxpayer Satisfaction Study," Minnesota Department of Revenue.

8 Minnesota Anniversary Project poll, Citizens League, 2006.

9 "How does Minnesota Compare? Fiscal Year 2004 Comparisons," Minnesota Taxpayers Association, June 2006. Rankings include the District of Columbia.

10 "2005 Taxpayer Satisfaction Study," Minnesota Department of Revenue.

11 "How does Minnesota Compare? Fiscal Year 2004 Comparisons," Minnesota Taxpayers Association, June 2006.

12 "No Revenue Shortage? Take Another Look," *Star Tribune* editorial, April 16, 2007.

13 Price of Government reports, Minnesota Department of Finance.

14 "Who Pays: A distributional analysis of the tax systems in all 50 states," 2nd edition, Institute on Taxation & Economic Policy, January 2003.

15 Tax Incidence Studies, Minnesota Department of Revenue, www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/incidence.shtml.

16 2007 Tax Incidence Study, Minnesota Department of Revenue.

17 Property tax simulations by Steve Hinze, Minnesota House of Representatives Research, www.house.leg.state.mn.us/hrd/issinfo/ptxsims.htm.

18 1999 and 2007 and Tax Incidence Studies, Minnesota Department of Revenue.

19 GDP estimates are from the U.S. Bureau of Economic Analysis. Sales tax estimates are from the Minnesota Department of Finance.

20 Based on Price of Government statistics, Minnesota Department of Finance.

21 From a presentation "Show us the Money (The Future)" by State Demographer Tom Gillaspy and State Economist Tom Stinson, available at: www.demography.state.mn.us.

22 2004 Taxpayer Satisfaction Survey: Corporate Franchise Tax, Minnesota Department of Revenue.

23 Slemrod, Joel, *National Tax Journal*, Volume LIX, No.1, March 2006, pp 57-75.

24 "The Individual Alternative Minimum Tax: 11 Key Facts and Projections," Tax Policy Center www.taxpolicycenter.org.

25 *Renew the Partnership: A principled approach to financing city government*, League of Minnesota Cities, January 2005, www.lmnc.org/library/FLGTaskForceReport.cfm.

26 Minnesota Anniversary Project poll, Citizens League, 2006.

27 Slemrod, Joel, *National Tax Journal*, Volume LIX, No.1, March 2006, p. 72.

28 The department worked with the nonpartisan Jefferson Center, which has conducted citizen juries on a wide variety of public issues. See: www.jefferson-center.org.

Appendix: Fiscal Conditions Survey

Table APPA: Survey response rates for all participating states

	Completed Surveys	Total Members	Response Rate
Georgia	113	505	22%
Illinois	281	1,119	25%
Iowa	85	876	10%
Kansas	184	627	29%
Tennessee	161	353	46%
Minnesota	421	831	51%
West Virginia	49	232	21%
Missouri	360	646	56%
South Dakota	87	309	28%
Michigan	147	533	28%
Florida	158	414	38%
Pennsylvania	24	82	29%
Total	**2,070**	**6,527**	**32%**

2006-2007 Fiscal Conditions Survey Instrument

1. Overall, would you say that your city is better or less able to…

a. Meet financial needs in fiscal year 2006 than last year? (*check one*) ☐ Better Able ☐ Less Able

b. Address its financial needs in the next fiscal year (2007) compared to this fiscal year? (*check one*) ☐ Better Able ☐ Less Able

2. Please indicate whether <u>FY2005</u> revenue shortfalls in the following areas were less than 10% or greater than 10% as a percentage of funding expected from each revenue source:

Check one box for each item on the list below. Shortfall = actual receipts fell below predicted or budgeted receipts. Not all revenue sources are available to cities in all states—in this case, please mark "not authorized."

	No Shortfall	Shortfall <10% of Expected	Shortfall >10% of Expected	Not authorized in my city
a. Property Tax Revenues	☐	☐	☐	☐
b. Fees, charges, license revenues	☐	☐	☐	☐
c. Sales tax revenues	☐	☐	☐	☐
d. Local income/commuter tax revenues	☐	☐	☐	☐
e. Lodging, restaurant, amusement, other tourist-related taxes	☐	☐	☐	☐
f. State revenues	☐	☐	☐	☐
g. Federal revenues	☐	☐	☐	☐

2006-2007 Fiscal Conditions Survey Instrument (cont'd)

3. Please indicate in Part A whether there has been an increase, a decrease, or no change in an item between FY2005 and FY2006 for your city. Please indicate in Part B whether it had no impact, a moderate impact, or a major impact on your city's overall FY2006 budget.
Check one box in Part A and one box in Part B for each item.

	PART A: CHANGE			PART B: IMPACT		
	Increase	No Change	Decrease	No Impact	Moderate Impact	Major Impact
a. Value of city tax base	☐	☐	☐	☐	☐	☐
b. Service needs of new development	☐	☐	☐	☐	☐	☐
c. Amount of federal aid to city	☐	☐	☐	☐	☐	☐
d. Federal environmental mandates	☐	☐	☐	☐	☐	☐
e. Federal non-environ. mandates	☐	☐	☐	☐	☐	☐
f. State environmental mandates	☐	☐	☐	☐	☐	☐
g. State non-environ. mandates	☐	☐	☐	☐	☐	☐
h. Restrictiveness of state tax and expenditure limits on cities	☐	☐	☐	☐	☐	☐
i. Public safety needs	☐	☐	☐	☐	☐	☐
j. Infrastructure needs	☐	☐	☐	☐	☐	☐
k. Human service needs	☐	☐	☐	☐	☐	☐
l. Education needs	☐	☐	☐	☐	☐	☐

	PART A: CHANGE			PART B: IMPACT		
	Increase	No Change	Decrease	No Impact	Moderate Impact	Major Impact
m. Cost of employee pensions	☐	☐	☐	☐	☐	☐
n. Cost of employee health benefits	☐	☐	☐	☐	☐	☐
o. Employee wages and salaries	☐	☐	☐	☐	☐	☐
p. Prices, inflation, cost of living	☐	☐	☐	☐	☐	☐
q. Population (# of people in city)	☐	☐	☐	☐	☐	☐
r. Health of local economy	☐	☐	☐	☐	☐	☐

4. Please indicate which actions your city has taken in FY2006 for the 2007 fiscal year:
Check one box for each item on the list; if your city does not have authority to take action regarding an item, please check the "not authorized" box.

	Significant Increase In 2007	Slight Increase in 2007	Maintain	Slight Decrease in 2007	Significant Decrease in 2007	Not Auth. in my city
a. Taxes…………………………………..	☐	☐	☐	☐	☐	☐
b. Reliance on ending balances/reserves….	☐	☐	☐	☐	☐	☐
c. Fees/charges/licenses increases…..…….	☐	☐	☐	☐	☐	☐
d. Growth rate of operating spending……..	☐	☐	☐	☐	☐	☐
e. Actual infrastructure spending…………	☐	☐	☐	☐	☐	☐
f. Actual public safety spending………..…	☐	☐	☐	☐	☐	☐
g. Other spending…………………………	☐	☐	☐	☐	☐	☐
h. Service cutbacks/elimination………….	☐	☐	☐	☐	☐	☐
i. Privatizing or contracting out………….	☐	☐	☐	☐	☐	☐
j. Productivity levels…………………….	☐	☐	☐	☐	☐	☐
k. Number and/or scope of interlocal agreements or other cost-sharing plans…	☐	☐	☐	☐	☐	☐
l. Size of city government workforce…….	☐	☐	☐	☐	☐	☐

Index of Tables, Charts, and Maps

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Chapter 1: City Fiscal Conditions

Chapter 2: Taxes, tax reform, and the public

Appendix

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