

## Understanding Minnesota's Big Picture

### Evolution of the Budget Crisis

The roots of Minnesota's budget crisis are in (1) unwise permanent tax cuts made in 1999-2000 at the height of the high tech bubble, as explained in "How the Minnesota Miracle Became the Minnesota Debacle;" (2) 10 years (2001-10) of two governors – Ventura and Pawlenty – and legislative leaders playing WITHWAGA (**W**ishful **T**Hinking **W**Aiting **G**Ame), the budgetary process game in which governors and legislators foist the Balanced Budget Bamboozle on themselves and the public; (3) two recessions, the second the worst since the Great Depression, which caused WITHWAGA to produce fiscal disaster; and (4) four long term trends that will continue to wreak havoc unless Minnesota's state-local fiscal system is redesigned. The trends are (1) ever greater mobility of capital and businesses, making it difficult to tax businesses and foolish to clobber production, (2) the economy's trend from goods to services, making Minnesota's sales tax increasingly outdated, (3) rising health care costs, causing fiscal trouble for covering both lower income uninsured residents and 300,000+ public employees and their families, and (4) the graying of Minnesota, with the promise of still more health care and long term care costs, and sharply diminished tax revenues as the sharply rising number of retirees buy more services and fewer goods, buy less overall, and have incomes that are both lower and more exempt due to Social Security being exempt and living in part off their savings. See "What's Wrong with Minnesota's Budget Process" below and "The Minnesota's Budget Is Balanced Bamboozle" to understand WITHWAGA

### What's Wrong with Minnesota's Budget Process?

Minnesota's budget process suffers from at least the following eight problems.

1. Projected current revenues and expenditures are not required to be in balance. Imposing this simple change by statute would make a world of difference. No longer could the beginning fund balance (a one time item) be spent on ongoing program expenditures. The fund balance as of the end of a biennium could be disposed of in any of a number of ways, which could be specified or left to legislative judgment.
2. The budget reserve is not large enough. Something in the 4-5% of total biennial expenditures probably would suffice. See the Budget Trends Study Commission report. The reserve should be set as a percentage, so that it increases automatically with growth in the budget, because the risk increases automatically with that same growth. This would place the reserve in the \$1.5-2 billion range. The targeted level recently was \$653 million, which is ridiculously low. The reserve should be, and has for years been, in addition to the cash flow account (recently \$350 million) which is what is needed to deal with the differences in the timing of receipts and expenditures that occurs without regard to economic

- fluctuations. The amount of the cash flow account should be reviewed for adequacy and changed if and when the fluctuations increase.
3. To prevent temptation, the statutes should provide for the disposition of surpluses. What to do with surpluses, once the budget reserve reaches a reasonable level and all school funding manipulations have been eliminated, could be the subject of a statute. There are numerous possibilities that would ensure that they are used for one time purposes and not ongoing commitments.
  4. Manipulation of school funding to plug state budget holes is too easy. The legislature uses two tools to force borrowing on school districts when it wants to spend more than the projected general fund balance – changing the year in which school districts recognize property tax revenues and changing the metering of state aid payments. Such measures probably need to be available in an emergency, but should be made unavailable by statute for setting the budget in the budget setting years – the odd numbered years. While the legislature could always amend the statute to continue this practice, differentiating in statute between plugging a gap that has unexpectedly developed and setting the budget in the first instance might work to reform this practice.
  5. Use of temporary tax increases should be considered. Either or both income tax surcharges or sales tax rate changes could be set to apply automatically under defined circumstances. Alternatively, the legislature could enact such changes on an ad hoc basis instead of following its historical practice of playing WITHWAGA.
  6. Inflation on the expenditure as well as the revenue side should be incorporated in the economic forecasts. The forecasts routinely report a rosier than real picture because inflation has been removed from the projected expenditures. Inflation should stay removed from the base line budgeting process; i.e., state agency budget proposals should not be allowed to assume inflation and then build from there, but the overall forecast should incorporate the State Economist's best estimate of inflation because the numbers reported are otherwise too rosy, and it is the numbers reported that get the media and public attention.
  7. The budget process focuses too much on inputs and not enough on results. The state should adopt outcome based budgeting to remedy this problem.
  8. Over \$1 billion per year (\$2 billion per biennium) of general fund spending goes to property tax aids and credits (PTAC) which are totally unaccountable aid to local governments. The PTAC should be repealed as part of the state-local fiscal system reform that clearly is required. Homeowner property tax relief would still be available through the property tax refund program, which could be used, along with redirecting state spending to specific items such as local employee health care costs, to prevent unacceptable property tax increases. See Minnesotans Should Demand Property Tax and Local Aids System Change below and the Minnesota Proposals section of the website.

Addressing the foregoing problems would end the budget process game WITHWAGA. WITHWAGA is the budget game that governors and legislators play. They regularly adopt out of balance budgets, wishfully thinking that economic growth will bail them out by producing more tax revenues than have been projected. It is difficult enough to rely on a forecast made in February to make budget decisions in May when the economy has clearly slipped in the interim, but this degree of WITHWAGA is inevitable. Compounding it with spending the beginning balance, having a grossly inadequate budget reserve, and manipulating school funding makes the game outrageous, and Minnesota now has the budget problem that validates this claim

**Won't Minnesota Quickly Recover Its Fiscal Health?**

No. The unwise permanent tax cuts in 1999-2000 remain in force, and the four tough trends (above) are getting worse, not better, from a fiscal perspective. Plus which, economists believe that the economic recovery will be slow, which diminishes the potential role of economic growth in ending the fiscal crisis.

**Economic and Demographic Reality – One Metroplex and Five Ruralplexes**

According to State Economist Tom Stinson and State Demographer Tom Gillaspay, Minnesota now consists geographically of one 17 county Metroplex and five multi-county Ruralplexes, with counties and Minnesota's total population of 5,263,493 (2007 estimate) distributed as follows:

<b>Twin Cities Metroplex</b>		<b>Southeast River Valley</b>		<b>Southwest Corn Belt</b>	
3,612,264		549,035		164,535	
		Blue Earth	59,723	Big Stone	5,473
<b>East</b>	1,148,355	Brown	26,344	Chippewa	12,645
Dakota	398,177	Dodge	19,787	Cottonwood	11,584
Ramsey	517,074	Faribault	15,128	Jackson	11,015
				Lac Qui	
Washington	233,104	Fillmore	21,086	Parle	7,414
		Freeborn	31,492	Lincoln	5,943
<b>West</b>	1,399,577	Houston	19,779	Lyon	24,940
Carver	88,384	Kandiyohi	41,763	Murray	8,657
Hennepin	1,157,283	LeSueur	27,840	Nobles	20,399
McLeod	37,130	Martin	20,731	Pipestone	9,342
Wright	116,780	Meeker	23,371	Redwood	15,851
		Mower	38,423	Rock	9,474
<b>North</b>	692,053	Nicollet	32,042	Swift	11,370
				Yellow	
Anoka	331,246	Renville	16,466	Medicine	10,428
Benton	39,308	Sibley	15,288		
Chisago	50,433	Steele	36,485		
Isanti	38,881	Wabasha	22,398		
Sherburne	86,308	Waseca	19,517		
Stearns	145,877	Watonwan	11,418		
		Winona	49,954		
<b>South</b>	372,279				
Goodhue	46,092				

Olmsted	139,418
Rice	63,034
Scott	123,735

<b>Northwest Valley</b>		<b>Central Lakes</b>		<b>Up North</b>	
	289,396		292,129		356,134
Becker	32,183	Aitkin	16,067	Beltrami	43,320
Clay	55,441	Cass	28,743	Carlton	33,990
		Crow			
Douglas	35,827	Wing	61,390	Clearwater	8,314
Grant	6,020	Itasca	44,278	Cook	5,356
Kittson	4,678	Kanabec	16,384	Hubbard	18,891
Marshall	9,781	Mille Lacs	26,171	Koochiching	13,506
Norman	6,822	Morrison	32,947	Lake	11,119
				Lake of the	
Otter Tail	58,437	Pine	28,229	Woods	4,279
Pennington	13,708	Todd	24,347	Mahnomen	5,074
Polk	31,023	Wadena	13,573	Roseau	16,177
Pope	11,110			St. Louis	196,108
Red Lake	4,122				
Stevens	9,742				
Traverse	3,793				
Wilkin	6,709				

The Twin Cities Metroplex consists of 17 counties in Minnesota (plus more in Wisconsin), not the statutory seven county Metro Area, because that is the geographic area that is part of a single, real world economic area in terms of economic activity, commuting and the like.

Ruralplexes are, in the words of Stinson and Gillaspay, “spatially separated neighborhoods,” defined by geographic contiguity and economic similarity. Minnesota’s 87 counties initially were configured roughly by the belief that a citizen should be able to reach the county seat within one day. That is now true at the state level, for St. Paul is accessible from anywhere in Minnesota in a day’s drive (not to mention flying) and Ruralplex citizens can drive to the largest city in the Ruralplex in a few hours at most.

### **Total Size of the Minnesota Government Enterprise**

Numbers are for one recent year – calendar 2007 for cities, counties, townships and special districts, fiscal 2008 (July 1, 2007 – June 30, 2008) for state and school districts.

State general fund budget -	\$16 billion
Total state revenues -	28 billion
Total state and local revenues -	52 billion
Total size of the Minnesota government enterprise -	42 billion

The total size is less than the total revenues because the revenues include \$10 billion of transfers between governmental units, mostly state aid to local governments, the largest share of which is aid to school districts.

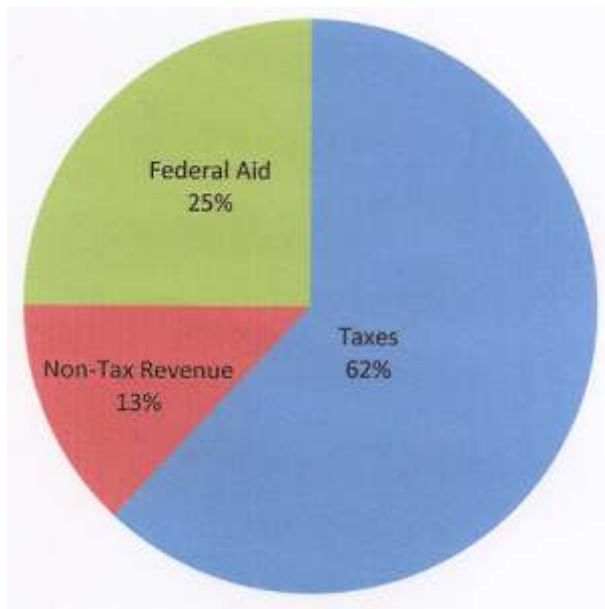
Almost all the attention goes to the state general fund budget, which accounts for only about 40% of the total size of the government enterprise. The remaining 60% tends to be more stable and to grow more slowly than the state general fund budget because the latter is funded largely by highly volatile income and sales taxes, while the rest is funded more by the comparatively stable property tax, non-tax fees and charges, and federal aid.

All of these governmental entities and functions are interrelated. The property tax is the main local tax, and also a state tax. The state sends a torrent of money to local governments to help them pay for what they do. That money comes mostly from income, sales and property taxes. If local governments perform more efficiently, property taxes can be cut and the state can spend more of its revenue stream on education, human services and ensuring that no Minnesotan goes bankrupt from a health care emergency – investing wisely in Minnesota’s people to enhance every Minnesotan’s chances of having a high quality life.

**Where the Money Comes From**

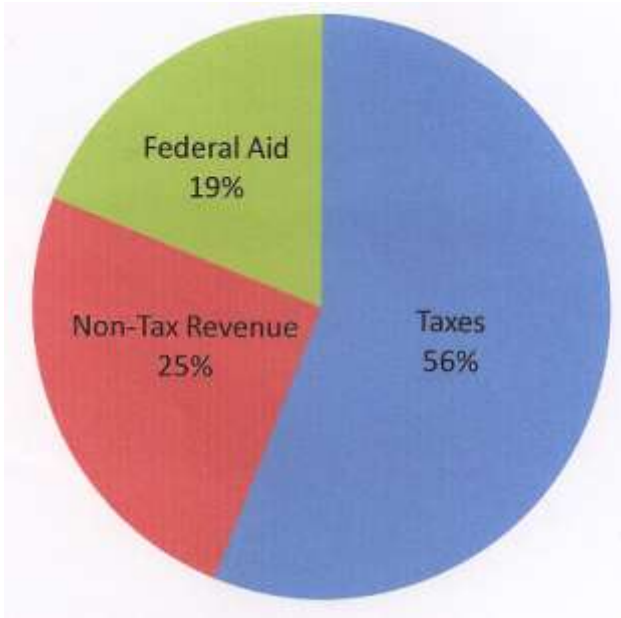
***State Revenues***

- Taxes 62%
- Non-tax Revenue 13%
- Federal Aid 25%



***Total Size of the Minnesota Government Enterprise***

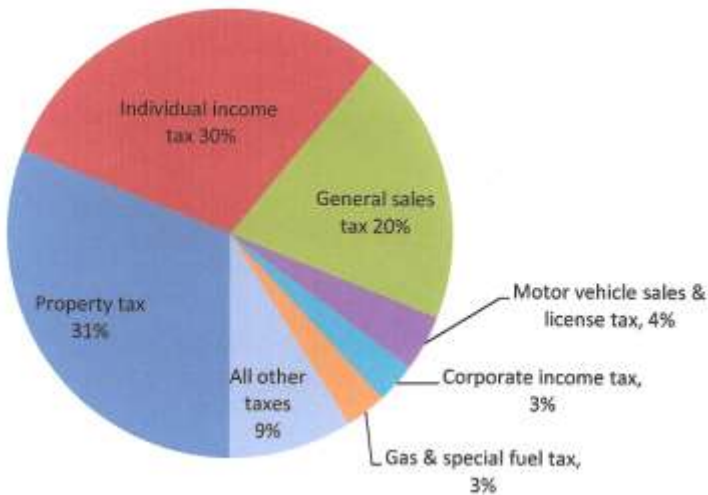
- Taxes 56%
- Non-tax Revenue 25%
- Federal Aid 19%



Non-tax revenue is much more significant overall than at the state level because both cities and counties raise major shares of their budgets through non-tax fees and charges.

***Taxes***

- Property tax 31%
- Individual income tax 30
- General sales tax 20
- Motor vehicle sales and license taxes 4
- Corporate income tax 3
- Gasoline and special fuels taxes 3
- All other taxes 9



The percentages by tax type are for Calendar 2008/Fiscal 2009 as reported in the February 2010 Forecast. The property tax was the largest tax from 1858 to the 1970s. The individual income tax has been the largest in most years since then, but the property tax occasionally claims the top spot. The general sales tax probably has been number three ever since its enactment in 1967.

**Where the Money Goes**

Nobody keeps track of where the money goes by meaningful categories on a government enterprise-wide basis. This is a significant weakness in governmental accountability to Minnesota’s citizens, and to the legislature and governor, and a significant impediment to identifying high potential opportunities for efficiency-increasing reforms.

STAFS pieced together the following gross estimates of where the money goes on a total government enterprise basis. These figures include a mix of recent years, as annual data is not made promptly available. Unfortunately, some of the reporting is done in categories so large and vague as to be meaningless, so STAFS did some estimating and categorizing to produce this picture of where the money goes. The picture is quite imprecise, and meaningful only in category rankings and rough orders of magnitude.

With apologies in advance for inevitable inaccuracies, here is where \$42 billion per year goes, using the categories developed by STAFS and described in “Where the Money Goes – Minnesota Government Entity Spending Categories.”

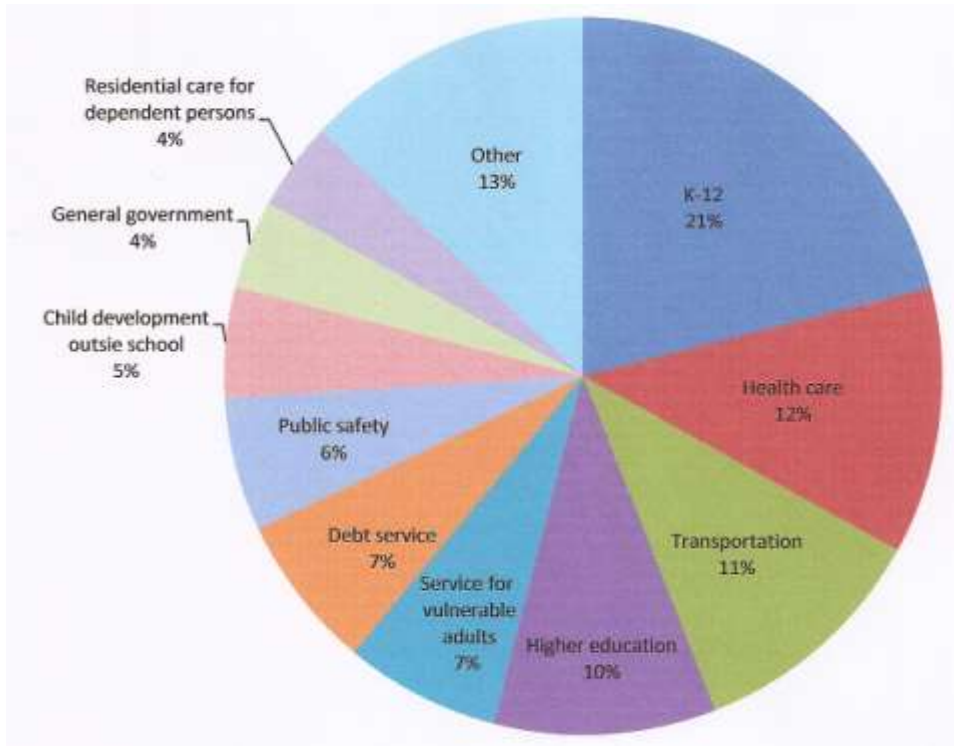
The big four, with totals ranging from \$4-\$9 billion per year:

- K-12 education 21%
- Health care 12
- Transportation 11
- Higher education 10
- Total Big Four 54%

The remaining six of the big 10, with totals ranging from \$1.5-\$3 billion per year:

- Services for vulnerable adults 7%
- Debt service 7
- Public safety 6
- Child development outside school 5
- General government 4
- Residential care for dependent persons 4
- Total Big 10 87%

Everything else combined 13%



The share of health care is understated, as it does not include the cost of health insurance for 338,000 public employees and their dependents. If that were included under health care, it would reduce every other category, and probably make health care instead of K-12 education number one.

The everything else category ranges from a high of 2% (\$850 million) for Other investments in human capital to a low of 0.2% (\$107 million) for Agriculture. Allowing for the weaknesses in the data, it still appears that the Big 10 are correctly identified and that no other category even comes close to the lowest of them.

### **Governmental Units in Minnesota**

The governments of Minnesota are approximately the following:

State	1
Counties	87
School Districts	348
Cities	855
Townships	1,787
Special Districts	<u>595</u>
Total	3,673

### **Governmental Structural and Operational Status Quo Prevents Getting Top Value for the Public Spending Dollar**

Governments **provide** services to residents. Each service is provided by the government **producing** the service itself or **purchasing** it from a third party – another government, a nonprofit organization or a business.

Minnesota's governments generally produce services themselves rather than purchasing them from third parties. The result is many small service providers producing services inefficiently.

Consolidation of contiguous governments sometimes can improve efficiency. So could specialization by some governments in selling services to others, or by private firms in selling services to multiple governments.

Among the questions Minnesotans should now be asking, on a community by community basis, are whether local citizens would be better off if their:

- Township hired their county or an adjoining city to provide various services?
- City hired their county or another city to provide various services?
- County combined with contiguous counties to provide various services?
- City merged with one or more contiguous cities or townships?
- School district did any of the foregoing with other school districts or, in the case of non-educational services, any other local government?
- Twin Cities metropolitan area were expanded in geographic scope and reduced in number of separate governments from the current hundreds?
- Township, city, county or school district purchased various services from private contractors instead of producing the services themselves?

Questions for the governor and legislators include whether Minnesotans as a whole would be better off if the legislature:

- Made it easier for local communities to address the foregoing questions?
- Imposed county level provision of some services now provided by cities where all the cities in the county are so small that county service provision would clearly be more efficient?
- Imposed some consolidations of local governmental units?
- Reformed the human services delivery system, which presently is straight out of the 19<sup>th</sup> century and treats counties ranging in population from 4,000 to 1,200,000 roughly the same?
- Reconfigured Twin Cities Metro Area governance to make the geographic scope of its governance correspond more closely to economic reality and reduce the very large number of separate governmental units now spending taxpayer money to provide services?
- Enacted a health care reform that ensured that no Minnesotan would be bankrupted by a health care emergency, and used the 338,000 public employees and their dependents as a market segment to introduce reforms that would cut the cost of health care for all Minnesotans?

For more specific possibilities, see Change Minnesota, Exhibit D, Changing the State-Local Government Relationship to Solve Minnesota's Too Many Governmental Service Producers Problem, and Exhibit E, SLFS, SLGR and Health Care Reform.

### **Minnesotans Should Demand Property Tax and Local Aids System Change**

Minnesota is in the midst of perhaps its greatest fiscal crisis ever. The daunting complexity of the state-local fiscal system, and especially its property tax and local aids

systems, should not stand in the way of change because the property tax and local aids systems exhibit four major problems:

- The state pays out approximately \$1.2 billion per year to local governments in property tax aids and credits in completely unaccountable fashion. This unaccountable stream of money flowing out of the state treasury would be gradually but quickly eliminated under the James Proposals. When you're short of money, shouldn't you stop pouring billions down a black hole?
- The state has no sensible standard for an expected level of effort by local property taxpayers as a foundation for property tax aids and credits paid to local governments. Looking just at 60 cities receiving over \$400 per capita in state subsidies from the largest state aid programs (and excluding small Greater Minnesota cities) in 2009 (before unallotments), state paid subsidies to cities range from zero to over \$800 per year per city resident. The property taxes paid by the owner of the average home in these cities for all local government services – city, school, county and special districts – ranges from \$325 to \$1,589 per year (in 48 of the cities less than \$1,000 per year), before taking into account the property tax refund program which protects homeowners against property taxes that are too high in relation to their incomes. So here are 60 Minnesota cities in which, thanks to state aid subsidies that the state plainly can no longer afford, the average homeowner pays from \$27.08 to \$132.42 per month (with those in 48 of the cities less than \$83.33 per month) for all local government services before considering what the homeowner can afford to pay based on income. As the late Governor Rudy Perpich once said, with a look of incredulity on his face, regarding his own father to STAFS' President: "He pays more for cable TV than for all his local government services combined, and he thinks his taxes are too high." Under the James Proposals, the legislature would allow local citizens to buy as much township, city and county services as they are willing to pay for, with relief based on homeowner ability to pay. Citizens and local officials would be systematically incentivized to find ways to provide local services more economically. See Exhibit B, Minnesota's Property Tax System and City Aids to understand how the property tax and local aids systems interact; Attachment B-1, City Aids and Property Taxes, for aid and property tax information on 496 cities; and Attachment B-2, Cities with High per Capita State Aids, for 60 cities with per capita aids in excess of \$400 per year.
- Legislators and local officials complain about lack of economic activity in much of Greater Minnesota, but the property tax system that they do not want to change causes business property in the highest tax rate city (Brown's Valley) to pay taxes at three times the rate that businesses in Edina (one example of a relatively wealthy city) pay. Under Minnesota's completely irrational taxation of business property, the rich get richer and the poor fall ever farther behind, as the tax system penalizes businesses for investing in cities where the jobs are needed the most. See Exhibit B, Minnesota's Property Tax System and City Aids, to understand how Minnesota's property taxation of businesses works in practice, and how businesses often pay three times the rate that homeowners pay (more than ten times on the Iron Range). Under the James Proposals, business property taxes would be much more even across the state, and they could be much reduced as well, if the legislature chose options laid out there which would stop clobbering

production in Minnesota and shift a substantial portion of the business tax burden onto out of state businesses selling into Minnesota.

- The existing property tax system encourages wasteful and environmentally degrading land use, and higher than necessary public infrastructure costs. Though not as immediately serious as the foregoing three problems, these are serious, directionally incorrect incentives. The James Proposals would facilitate reversing the incentives to encouraging efficient land use, redevelopment of already developed land over green field development, conservation of land and water, and efficient infrastructure spending. And they could be refined to use the tax system to create directionally correct incentives to minimize many forms of pollution and encourage energy conservation and alternative energy sources.

income uninsured residents and 300,000+ public employees and their families, and (4) graying of Minnesota, with the promise of still more health care and long term care costs, and sharply diminished tax revenues as the sharply rising number of retirees have lower incomes and buy fewer goods that are subject to sales tax.

### **Won't Minnesota Quickly Recover Its Fiscal Health?**

No. The unwise permanent tax cuts in 1999-2000 remain in force, and the four tough trends (above) are getting worse, not better, from a fiscal perspective. Plus which, economists believe that the economic recovery will be slow, which diminishes the potential role of economic growth in ending the fiscal crisis.