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Citizens League
530 Syndicate Building
Minneapolis, Minnesota 55402

August 19, 1971

TO: Members, Citizens League Board of Directors

FROM: Community Information Committee

SUBJECT: Supplementary Statement on Revenue Distribution

"This is a report on revenue distribution . . . and not on 'taxes' . . . quite deliberately."

That was the first sentence in our report "New Formulas for Revenue Sharing in Minnesota" issued one year ago.

Perhaps the most extensive and enlightened discussion of state-local finances in Minnesota history has occurred since then, within and outside the State Capitol.

We made a particular point in our report of the importance of revenue distribution: that *distribution* of funds to the various units of local government *should be every bit as important* and receive the same degree of attention *as taxes* (i.e. how much to increase or decrease one tax or another). We did not want the issues of how money is apportioned among various units of government to be overshadowed by the issues of how the money is raised. We also stressed that Minnesota has one fiscal system, with state and local elements. The state and local elements affect each other and cannot be considered separately. Citizens increasingly understand that a significant part of the effort this year is to change the "mix" of property and non-property, state and local, revenues.

The Governor and Legislature are undertaking a bigger and more comprehensive effort than ever before to make basic improvements in our system of state-local taxation and revenue distribution. Never before have proposals--even the most modest ones--been so ambitious.

The process is exceedingly difficult. The Governor and the Legislature have the task of assembling a package containing the elements of revenue-raising (which we did not discuss in our report) as well as revenue-distribution. It is not altogether surprising, nor is it necessarily undesirable, that they are finding it necessary to take more time in working out a final compromise than Minnesotans have been accustomed to in the past. But we suspect a decision involving some $600 million in new revenue would not be undertaken with any less debate by a private business.

Now, as the Governor and Legislature start another chapter in their effort to reach agreement, it is important that they resist the temptation to simply patch up the present revenue distribution system and go home. Because of weariness or frustration, this could well be an appealing option to many legislators, as well as many people in the general public.

Yet, the Governor and Legislature already have reached a point where they are very close to accomplishing major reform in the revenue distribution system. We do not underestimate the significance of the disagreements which still exist over how to raise the money. But they have agreed, implicitly, that $600 million in new revenue could be raised. And this decision presents the state with an opportunity which is unlikely to arise again for several years or, perhaps, even decades: to infuse a substantial amount of additional non-property dollars into local government and to improve the method by which these dollars are distibuted.

In a legislative session when big, new dollars are not involved, distribution formulas may be tampered with, but, as a practical matter, few real changes are possible. The process of obtaining agreement on new formulas is always painful. It is virtualllly impossible unless enough new money is available to make sure no unit of government receives less than it is receiving now. Thus, this legislative session, which is likely to produce the largest new revenue package in the state's history, gives us the infrequent opportunity to make the fundamental improvements in distribution formulas.

Accordingly, in this session Minnesota has a chance to demonstrate to the rest of the nation its ability to be a leader in working out the critical issues of state-local finance which are plaguing every state and which--because they have not been solved in the state legislatures--have prompted local governments to seek most of their financial solutions in Washington.

We urge the Governor and Legislature to reach for the opportunity which is theirs now to pass so much more than just a "tax bill" or a "tax relief bill," and to pass a fundamental reform in the state's fiscal system. And we urge the public to be patient and understanding as this process takes place, with the knowledge that the reward can be a vastly improved method of utilizing the state's public dollars.

I. School Finance

The school aid question has dominated the entire state-local finance issue, with the Legislature debating the most far-reaching changes in the school aid fomula since the basic structure of the present formula was established in 1957.

Our report recommended (a) a redefinition of pupil units to account for differences in pupils due to socio-economic backgrounds as well as differences in grade levels (b) a change to basing aid on the number of pupil units enrolled in school rather than the number in attendance (c) consolidation of several separate aid payments which now are made for school operating purposes (d) state support up to the average operating expenditure per pupil unit, but short of state support at this level, a formula which accomplishes equalization of aid up to the average operating expenditure per pupil unit (e) taking into account other governmental service needs in equalization (f) requiring school districts to report expenditures by each school and to develop and measure educational objectives (g) imposing the same type of levy restraint on all school districts.

If action so far is any barometer, it appears as if the Legislature is accepting the need to recognize other differences, besides grade levels, in weighting pupil units. Also there is almost universal recognition in the Legislature now to base aid on enrollment of students rather than attendance and to impose the same type of levy limit on all school districts.

The following areas, too, ugently need attention:

A. Impact of Other Governmental Service Needs--Whatever the package finally agreed to, it is likely that the vast majority of the additional non-property dollars for local governments will be in the form of state aid to school districts. Currently the costs of education represent widely differing proportions of the total costs of government at the local level. If the other costs of government are not recognized in the final package, the Legislature will end up "overbalancing", so to speak, the state aid in favor of those communities where education makes up the lion's share of local government costs. Communities where other services, such as welfare, police and fire, are as dominant as the costs of education, will not be significantly helped. It has been apparent for some time that agreement would be speeded if the school aid proposal were accompanied by some provision reflecting these differences among localities.

Two such options are available . . . and were, in fact, discussed in earlier stages of the fiscal debate. One was the proposal--originally advanced in our report "New Formulas for Revenue Sharing in Minnesota"--to reflect in the equalization formula the differences among school districts in the proportion of the local tax base "claimed" by other-than-school-operating expenditures.

This was laid aside when the Legislature turned for a time to consider a second option: state assumption of local welfare costs.

The decision to incorporate neither of these in the package approved by the House and Senate in mid-July was a troubling factor at that time. The need will remain to address this fundamental problem when the discussions resume. An option such as one of the above, combined with an improved municipal aid program as discussed elsewhere in this statement, needs to be adopted as a way to avoid overweighting property tax releif in some communities at the expense of others.

B. A Formula Suitable for the Entire State--It has proved extremely difficult to write a single formula--one set of numbers--for school districts which vary so widely as Minnesota's in valuation and in expenditures per pupil unit.

In part, we continue to believe, the solution to the disagreements arising out of these differences must be resolved by returning to the policy on school finance laid down by the Legislature when the current school aid formula was enacted in 1957. That is: all districts are to be enabled to finance a comparable and adequate level of expenditure with equal property-tax effort. As in 1957, all districts would be required to pay a uniform percentage of their valuation in local effort, with the state paying the balance up to something closely approximating the actual expenditure per pupil unit. Our report pointed out the gradual erosion since 1957 of the degree of equalization in the school aid formula. This has meant that the poorer districts have been obliged more and more to make relatively greater local effort. The framework of the 1957 formula has not changed. But in the intervening years, as school costs have increased, a key figure in the formula (called the foundation base), which was supposed to represent as closely as possible the statewide median operating expenditure per pupil unit, has not kept pace with the increase in costs. Our report recommended that equalization now be restored by returning the foundation base to the current average (or median) operating expenditure per pupil unit. We renew this recommendation today.

The effort, this year, to accomplish this equalization has been frustrated by the impact of such a formula on high-valuation districts that now are spending significantly below the statewide average per pupil unit. Resistance has developed because of a fear that the formula would impose too great a local effort requirement on such districts. A partial solution, as our report recognized, can be found by introducing into the formula an option for such districts to elect not to be brought up to the higher expenditure level--and to the higher level of local property tax effort--otherwise required. We urge this option be presented and evaluted as the new discussions begin. It should be fully recognized that such an option does not enable the state to require a higher level of expenditures per pupil unit in such districts--a requirement which many feel is desirable to accomplish an even greater degree of equalization of educational opportunity. But this would be a comparatively small price to pay for a major reform in the aid formula for the entire state. Another partial solution to the problem of the high-valuation, low-expenditure districts could be to provide equalization up to a regional average expenditure per pupil unit, rather than a statewide average.

Also, as a corollary to our recommendation that the foundation base or support level be the current average operating expenditure, and not some artificially-lower figure, the Legislature should not artificially inflate the foundation base. The foundation base should include only those operating expenses which are financed by foundation aid and local property tax. It should not include operating expenses which are financed from state or federal categorical aids.

C. <u>A single Foundation Aid Plan</u>--To make equalization really work, our report recommended that certain other general state payments to school districts which are used to finance operating expenditures be discontinued, thereby freeing such other payments to help finance the foundation aid plan. We repeat that recommendation. Specifically, formulas which distribute funds based on the location of children between 6 and 16 years of age whether or not enrolled in public school, (the sales tax per-census-child aid) and which distribute funds based on the location of personal property which was made exempt from taxation in 1966 should be discontinued. School districts can be "grandfathered" so that no district receives less under the new aid plan than was received, in the aggregate, from the various separate plans.

D. Reporting Costs and Developing Objectives--Particularly with the likelihood of substantial increases in state aid for disadvantaged children and the need to make sure the funds are spent on the disadvantaged, we renew our recommendation that school districts be required to report pupil unit expenditures by each school building. This *can* be done.

We realize the effort by school districts to define and measure educational objectives is only beginning. But we believe the Legislature should, at a minimum, instruct school districts and the State Board of Education to report on progress in this area.

A set of reports, stating their progress and problems, should be required.

E. Levy Restraints--The Legislature has been keenly aware of the importance of this issue since it convened last January. Nevertheless, the Legislature continues to be faced with major difficulties in devising a plan which is effective, treats all districts alike, and preserves a degree of local autonomy.

It may be helpful at this time to restate our proposal and the rationale behind it. We recommend that each locally-elected school board be authorized to determine its own level of expenditures and stand responsible to its electorate. At the same time, we recognize the strong state interest in the level of local school expenditures because of the large amount of state aid which is used to finance the expenditures. We recommend that if school districts increase their spending at too high a rate, they lose some of their state aid. Thus a district, if it wanted to, could increase its expenditures at a higher-than-acceptable rate, but it would become ever-more expensive to do so in terms of local taxes. Meanwhile, the state's interest would be preserved, because the total amount of state aid distributed to that school district would be reduced. Such a levy restraint accepts a situation of shared power and responsibility between the state and the local school board. It is more flexible--designed to recognize different desires of school districts--than, for example, an absolute limit in dollar or mill levy terms. We believe it also will be more effective. It can be adjusted, as desired, so that school districts whose expenditures are below the statewide average can have a more liberal allowable increase before withdrawal-of-aids than districts above average.

II. Municipal Finance

Here the situation is quite different but every bit as important. Unlike school finance, the municipal finance question involves needs and problems which have not been thoroughly explored. In fact, it is very possible that inaction by the Legislature in this area could produce more drastic side effects than anything else. A revenue distribution package which fails to provide adequate non-property revenues from the state for municipalities will be an open invitation for municipalities to impose their own local non-property taxes. Only certain municipalities, for example, those with large shopping centers where sales tax receipts are concentrated, would benefit from municipal sales taxes. Other municipalities would gain very little. It is more likely that they would lose at the expense of the winners.

In effect, inaction by the Legislature on this question means that the state would be adopting a policy that additional non-property revenues should be distributed to municipalities on the basis of the place of collection of the funds, without regard to a municipality's need for revenues. It would be directly contrary to the beginning step laid down in 1967 with the initial distribution of a portion of state sales tax receipts to municipalities.

Our report urged that the state assume the responsibility for levying and collecting additional general non-property taxes, such as sales and income taxes, and return an increasing share of the revenue from such non-property taxes to municipal government. We urged that the formula for distribution of such revenues take into account a municipality's relative need for funds and its ability to raise money locally. We urged that the Legislature prohibit municipalities from levying local sales or income taxes.

The various proposals which have been actively considered reveal the Legislature has not so far thought beyond an interest in imposing strict limits on the extent to which municipalities may levy property taxes and in freezing the present amount of state non-property revenues which are returned to municipalities--denying them even a share of the natural growth from present revenue sources. While actively discussing ways to limit municipal property taxes, the Legislature ironically has not considered limits on municipal non-property taxes. In fact, it may not be recognized that the imposition of strict property tax limits and the freezing of state non-property funds is opening the door to a rash of local non-property taxes, producing one of the most inequitable forms of distribution. In addition, it may not be recognized that such actions would restrict the state's ability to use these non-property revenue sources in the future.

We urge the Legislature to address this problem when discussions resume, and to write a policy on the future use of non-property revenues by local government. Major reform can be accomplished with what are--relative to what is involved in the school aid formula--minor sums of money.

A proposal approved by the House Tax Committee during regular session would represent a good starting point. It would consolidate the various shared taxes into the state general fund; appropriate money out of the fund to municipalities in a single consolidated payment; guarantee all municipalities as much as each is receiving at present; provide for the growth in the consolidated payment to be distributed on a basis more nearly approximating relative need and ability to pay, yet guarantee each area of the state its fair share; and prohibit local non-property taxes. It would also, as a result, make it possible for the Legislature to maintain a coherent policy in this state over the future use of the general non-property sources.