CITIZENS LEAGUE
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Minneapolis, MN 55402

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STATUS REPORT ON SPENDING-TAX DECISIONS FACING GOVERNOR AND LEGISLATURE IN 1981

The Tax and Finance Task Force of the Citizens League this year is following the biennial budget-making process for the state, from the beginning stages of discussion this fall on through to final action by the Governor and the Legislature in May 1981.

We began meeting in early October. This report is the product of our first several weeks of work, during which we have tried to gain a general understanding of the scope of the budgeted revenues and likely expenditures, and the choices which need to be made.

From time to time over the next several months we may make proposals ourselves, but much of our effort will be directed to improving general understanding and in highlighting the major choices.

Thus, we are taking the liberty of sharing this status report with others. We would welcome readers' comments and suggestions.

Official information still is sketchy and may remain so until the Governor's budget message is delivered in late January. Nevertheless, it is possible for discussion to commence now, using whatever information can be assembled from various sources.

1. The Governor and the Legislature in 1981 may face the toughest spending-tax decisions in the state's history. Broadly speaking, these decisions divide themselves into three related, but separable, parts.

   a. Balancing the general fund budget

      The State Department of Finance has estimated preliminarily that the increase in available revenue for the upcoming biennium -- assuming no change in tax rates -- could range from about $1.2 billion to $1.6 billion, depending upon what happens to the economy. Department officials told us that for purposes of budget planning for the next biennium, the lower figure is more likely. The Department is expected to make an official estimate for budget-making purposes in late December.

      On the expenditure side, the Department of Finance has not made any projections, and none is likely until the Governor submits his budget message in January. Nevertheless, persons who follow the budget process have developed informal, not-for-attribution, projections. Four major categories take up the bulk of the existing budget and are most likely to receive the largest shares of increases in spending: school aid, welfare, property tax relief, and state salaries and supplies. If spending cuts made in 1980 are restored, additional expenditures would be required. Any planned reserve or balance on hand at the end of the biennium would have to be factored in. The range in projections of increases in the general fund budget for the next biennium are from $1.4 billion to $2 billion.

Thus it can be seen that balancing revenues and expenditures will not be easy. Depending upon assumptions, expenditure projections could exceed income projections by up to $800 million.

b. Balancing the trunk highway fund budget

A substantial proposal for increasing state spending for highways is likely. Two state task forces -- one appointed by the Governor, the other by the Legislature -- are preparing recommendations. The Minnesota Department of Transportation has estimated a "minimum" additional requirement of state funds for construction over the next biennium at $223 million. The task forces may recommend a combination of increases in the state gasoline tax and motor vehicle license fees, plus general obligation bonds which would be repaid with revenues from the general fund.

c. Determining the size of the biennial capital budget

Two guidelines will be used in submitting a capital budget in the Legislature, according to officials in the Department of Finance. The first guideline is that debt service (payment of principal and interest on outstanding general obligation debt) is not to exceed 2½ per cent of total general fund revenues. The second guideline is that the total outstanding general obligation debt should not exceed 2½ per cent of personal income in the state. These guidelines approximate the situation as it actually existed for the fiscal year ending June 30, 1979, according to the Department of Finance.

General obligation bonds in the vicinity of $350 million would keep debt service and outstanding debt within these guidelines for the next biennium, according to the Department of Finance. However, there is likely to be pressure to go higher. For example, as noted above, proposals are expected for general obligation bonds for highways. The University of Minnesota is seeking general obligation bonds for a $230 million new hospital. Hospital revenues, not state taxes, would be expected to repay the hospital bonds, but taxes would be pledged if necessary.

Complicating the bonding problem are high interest rates which would be paid on new bond issues, increasing the amount of debt service that would be required.

The state constitution limits general obligation bonds to a period of 20 years.

2. The problems in 1981 will differ from past sessions because growth in state revenues has been deliberately restrained by the adoption of indexing of the individual indome tax. Indexing slows, but doesn't stop, the increase in revenues. Revenues continue to rise as incomes rise. Indexing requires that decisions about increasing taxes must be more direct, through changing rates instead of being automatic as inflation pushes people into higher tax brackets. If the 1979 Legislature had not indexed the individual income tax, projected revenues for the upcoming biennium would be about $600 million higher, assuming a 9.5 per cent inflation rate, according to the Minnesota Department of Revenue. Under indexing, a pledge not to increase tax rates -- which the Governor already has made for 1981 -- means more than it used to. Formerly, Governors and Legislatures could enjoy the automatic growth in revenues as people were pushed into higher tax brackets, without imposing a direct increase

in rates. Now, that benefit is gone. Rates would need to be increased to capture revenue which formerly flowed in automatically.

3. Two factors normally not present add to the 1981 problem. First, the state is expecting to start the next biennium with essentially a zero balance in the general fund. The balance at the beginning of the current biennium was about $250 million. Second, state agencies and local governments were ordered to cut back expenditures in the current biennium by $195 million, to head off a projected deficit. If increases in spending levels for the next biennium are determined on a base that doesn't include the $195 million cut, total spending requirements will be higher. Since the cut was ordered, an additional $45 million deficit in the state's welfare budget has developed.

4. The budgetary problems facing the Governor and the Legislature in 1981 to a major degree involve questions of taxation and spending of cities, counties and schools. It is necessary, therefore, as a prelude to discussing budgetary issues and choices that will be present in 1981, to remind ourselves of certain aspects of the relationship between the state and its local units of government.

   <u>When local governments increase property taxes, state appropriations increase, too, automatically</u>. Under existing state law, the state pays part of the property tax bill imposed directly on homeowners and farmers, and indirectly on renters. Thus, as the property tax levy increases, so does state aid.

   For 1981, the state is paying 58 cents of every dollar of homestead property taxes, to a maximum state payment per homeowner of $650. This is known popularly as the homestead credit. At least two-thirds of the state's homeowners still are below the maximum. In addition, homeowners and renters below $36,000 income may recieve a rebate if their net property taxes exceed a certain percentage of their income. The law assumes that 23 per cent of rent, exclusive of utilities, constitutes property taxes. The combined benefit of the homestead credit and the income-based rebate (popularly called the "circuit-breaker") may not exceed $1,000 annually per household.

   The state also pays 17 mills of the property tax levy on the first 240 acres of an agricultural homestead, and 10 mills of the levy on the balance of the farm.

   Assuming no change in state law concerning these provisions, one legislative source has estimated that state appropriations for these purposes only could increase by more than $300 million in the next biennium. The Department of Finance has not yet made an official projection.

   <u>Although the state government itself doesn't collect property taxes, it does require a uniform local levy for schools</u>. The state has power to levy property taxes, but has not chosen to do so since 1966. The state requires school districts, however, to impose a common mill rate (23 mills for taxes payable in 1981). By adjusting the level of the mill rate, the state can affect the degree of state aid that will be given to each school district. During the last nine years, the Legislature has dropped that rate from 30 mills to 23 mills, and has made up the difference with more state aid. If no change were made in state law, that rate would fall further, to 21 mills, for taxes payable in 1982.

   The Legislature makes up the difference between what that mill rate raises in each school district and a certain dollar amount of spending per pupil unit enrolled in school. For the 1980-81 school year, the amount is $1,265 per pupil unit. Each school district is guaranteed this much money, irrespective of how much the common mill rate happens to raise.

The Legislature has been receiving growing pressure in recent years to reduce the common mill rate, because some school districts with a large amount of taxable value relative to the number of pupils have been raising all their money from the common mill rate, thereby receiving no state aid. If the Legislature keeps the common mill rate sufficiently low, it can provide aid to almost all school districts, but this requires more state aid. On the other hand, if it allows the common mill rate to increase, it can reduce the amount of state aid required while preserving a common level of effort in each district.

The Governor has given preliminary indications that he will recommend that the common mill rate be kept at 23 mills for the next biennium. His preliminary estimate of additional state aid required for the school aid formula is approximately $330 million.

<u>The concept of school district "equalization" can be interpreted differently</u>. Some persons contend that school district equalization means equal spending per pupil. Others contend that it means equal tax resources behind each pupil. (That is, spending can vary, so long as the same amount of tax effort is required to produce the same number of dollars from one district to another.)

<u>The state constitution requires that cities and counties share in every dollar raised from the state gasoline tax and state vehicle license fees</u>. There is considerable controversy over whether to increase the gasoline tax or license fees for construction and maintenance of state highways. However, under the constitution it isn't possible to give every dollar of increase in the gasoline tax or license fees to state highways. The constitution gives 62 per cent to state highways, 29 per cent to counties, and 9 per cent to cities over 5,000 population. Thus, counties and cities will benefit automatically if the gasoline tax and vehicle license fees are raised for state highways.

5. These very difficult choices on spending and taxes raise questions about the process which the Governor and Legislature follow in making their decisions.

   a. Do agencies, units of government and others who advocate higher spending levels have a responsibility to suggest -- at the same time -- where the money should come from?

   b. Do those who advocate reduced taxes have a responsibility to suggest -- at the same time -- where the spending cuts should be made?

   c. How can the Governor and Legislature make informed choices when they must decide between budget requests and higher levels of taxation?

   d. Should the total spending and taxation level be the sum of individual, separate actions, or should the total spending and taxation level be predetermined, with the remaining questions being how to divide the total among competing interests?

   e. What can the Governor and Legislature do in 1981 to make the budget dilemma easier in 1983 and subsequent bienniums? Are there fundamental changes in service delivery that could be made that would alter the nature of requests which come in each biennium?

   f. Is it important to adjust the times when state obligations are paid to avoid cash flow problems at different times of the year?

   g. What should be the structure of legislative committees for considering budget questions?

6. Bringing the general fund, trunk highway fund, and capital budgets into balance will require the Governor and Legislature to make several choices among competing interests:

   a. What significance should the rise in the rate of inflation represent in determining upcoming budgets for state agencies and local governments? Is it a "floor"? A "ceiling"?

   b. Where can services be improved or maintained without allowing spending to rise above available revenues at existing tax rates?

   c. Should state tax rates be held constant?

   d. Should indexing continue to be related to the increase in the Consumer Price Index?

   e. Are there ways to increase revenues without increasing rates of taxation, such as extending a tax to now-exempt items or income?

   f. Should the state itself levy property taxes?

   g. Should increases in state aid to schools, counties and cities be held down and, instead, should these units be allowed to increase property taxes?

   h. If the state allows higher local property taxes, should it continue to pay -- as it does now -- a majority of the property taxes levied on homeowners, through homestead credits and circuit-breaker payments?

   i. If the state allows higher local property taxes for schools, should it continue to "neutralize" differences in tax base among different districts? How can this be done without requiring more state aid?

   j. Should non-property taxes be levied below the state level? If so, over what area should they be levied?

   k. Should revenues now available to the general fund be used to pay expenses in the trunk highway fund?

   l. Should the trunk highway fund expenditures be financed out of current revenue only? If not, what source of revenues should be pledged to repay bonds?

   m. Should the state gasoline tax be increased to finance the trunk highway improvements? Can user tax revenues be relied upon in coming years to pay for highways if people drive less and use more fuel-efficient vehicles?

   n. Should the Governor and Legislature build a reserve into the next biennial budget? How large?

   o. Should the $195 million cut be made up in the next biennium or should additional increases start from the lower level?

   p. Should the state make capital improvements now, to avoid higher operating expenses later on, even if it means an increase in debt service payments from the general fund?