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To: Members of Property & Local Tax Division

From: Chair Youakim

Subject: Local Sales Tax Goals and Standards

2019 Changes

From 2011 to 2018, cities had referendums on their local sales tax proposals before submitting them to the legislature for approval. In many cases, these referendums did not make clear how much money was being raised for different projects. Sometimes the projects were specifically defined with the amounts raised for them, and other times only general spending areas were mentioned. And in the years leading up to 2019, the uses of local sales tax revenue expanded significantly. As a result the 2019 legislature changed several statutes surrounding the approval process for local sales taxes.

These changes required cities to submit information to the legislature which would include a resolution passed by a city council, detail on the exact number (no more than 5) of projects and how much revenue would need to be raised to fund them, and documentation of the projects regional significance. In addition, the law change allowed voters to vote separately on different projects rather than the package as a whole. Another change reverted to the pre-2011 policy of requiring cities to come to the legislature for approval before holding their referendum.

The 2019 law change also included this purpose statement in statute for local sales taxes:

"Local sales taxes are to be used instead of traditional local revenues only for construction and rehabilitation of capital projects when a clear regional benefit beyond the taxing jurisdiction can be demonstrated. Use of local sales tax revenues for local projects decreases the benefits to taxpayers of the deductibility of local property taxes and the state assistance provided through the property tax refund system and increases the fiscal inequities between similar communities." -297a.99, subd. 1a.

History and Goals of local sales taxes

As part of the Minnesota Miracle in 1971, the legislature enacted a prohibition against new or increased local taxes on sales or income (M.S. 477A.016). The goal was to reduce local property taxes with state aids instead of new local-sales tax revenues, and to maintain some control over local fiscal disparities. Many states have more significant local sales taxes than Minnesota, while Minnesota has more robust local government aid than those states. Under the local income and sales tax prohibition, new local sales taxes were limited to those specifically authorized by state legislation (and a few cities that were grandfathered in), except for the general authority for lodging taxes.

A 2004 study on local sales taxes by the Department of Revenue stated, "*Local sales tax plays a valuable but supporting role in the larger picture of state and local government financing. The local sales tax is best used as a mechanism for the financing of large, special, multi-jurisdictional capital projects rather than as a replacement for property tax revenue to fund general expenses of local government*."

So the principal goal of local sales taxes is to allow cities to raise revenue to pay for capital projects that provide benefits to beyond those that pay property taxes in the jurisdiction. This was exemplified with a 2002 authorization of a Central Minnesota Cities[1] local sales tax rate of 0.5% to pay for improvements to the St. Cloud airport. That proposal had broad support across multiple jurisdictions to help pay for a capital project that would not otherwise receive funding.

Tradeoffs that local sales taxes present

The sales tax is the most regressive of the three major tax types (income, property, sales) in Minnesota. In January 2015, Minnesota had an average 7.20% combined state and local sales tax rate. Since then, the average combined state and local sales tax rate has climbed to 7.46%. Some make the case that there are no issues with the combined state and local sales tax rate continuing to climb since it is largely due to decisions made by voters at the local level. If that is so, then local governments may also want to bring local income taxes to the voters as well. 17 states allow local income taxes, primarily across the Rust Belt area of the United States.

If instead the general consensus of the committee is that the legislature should maintain a strong review of local taxes in Minnesota that go beyond the property tax, legislators should be aware of other tradeoffs that local sales taxes present. Unlike the property tax, local sales taxes are exported to non-residents that are not able to vote on whether or not the tax should be instituted. This is why multi-jurisdictional compacts are generally a better approach for pursuing these taxes.

One of the main reasons that Minnesota has not traditionally embraced local sales taxes as much as some other states is that they can exacerbate inequities between cities that in many cases are similarly situated. If Bloomington instituted a local sales tax, it would raise much more revenue at a faster rate than if Brooklyn Park or Plymouth did, even though they are similarly sized. There are also many “bedroom” communities in Minnesota without a significant retail base, and legislators should consider whether or not they want to try to maintain a relatively level playing field between those cities and ones with a larger commercial industry.

Project Standards for Local Sales Taxes

It has at times been difficult for legislators to objectively assess the quality of a proposed local sales tax. Unlike bonding projects which are capped by a target, there’s not a limit of local sales tax revenue raised that caps the number of projects in any given year. Nor is there any required minimum for approving a certain number of referendum each year. So there isn’t the kind of value in committee members ranking different proposals, since the choice for each local sales tax is binary.

But given how much time and energy local governments can put into these local sales tax proposals, it is imperative that the legislature set some sort of standards by which cities and counties can measure them. It’s not possible to create an equation that could automatically assess whether or not a proposal was strong or weak, but the Property & Local Tax Division could set standards that proposals should meet. Based on Minnesota statutes, past research, discussion in the Property & Local Tax Division in 2020, and recommendations from the 2004 Department of

[1] The cities were St. Cloud, Sauk Rapids, Sartell, St. Augusta, and Waite Park

Revenue Local Sales Tax Report, below is a list of possible standards the legislature could consider.

Specific Listing & Cost of Individual Projects

In many ways this requirement is the minimum threshold for any local sales tax proposal. Minnesota statute (297a.99 subd 2) requires the local resolution to provide a detailed description of no more than 5 capital projects that will be funded with the revenue from the tax, the amount of revenue for each specific project, and the estimated amount of time to raise that revenue. This standard would not be met by local governments that propose new local sales taxes for general spending in one area or another.

Local sales taxes must only be used for capital projects

Minnesota statute requires that the proceeds of local sales tax revenue "be dedicated exclusively to payment of the construction and rehabilitation costs and associated bonding costs related to the specific capital improvement projects," (297a.99 subd. 3). In 2019, additional requirement language was added reinforcing this standard, saying "clear regional benefit beyond the taxing jurisdiction…be demonstrated," (297a.99 subd. 2).

"Capital project" is not defined in local sales tax statute. Guidance around the definition of capital project for bonding purposes has often said that a capital project must be substantial, extend the useful life or substantially increase the value of the fixed asset, and not be predictable or recurring (as repairs would be). Capital projects for bonding are generally to acquire or improve fixed assets, such as land or buildings. The fixed asset must be long-lived in those cases.

Use of the revenue must be significant for non-residents, preferably at least equal to the portion they pay

In 2019, changes were made to Minnesota statute requiring that cities provide "documentation of the regional significance of each project, including the share of the economic benefit to or use of each project by persons residing, or businesses located, outside of the jurisdiction," (297a.99 subd. 2).

The idea that uses of local sales taxes be for projects with regional significance was not a new one. The 2004 Department of Revenue Local Sales Tax report wrote that "*Local sales tax should not be looked to as a replacement for, nor as a significant offset of, property taxes. Local sales taxes can, under certain circumstances, however, be a useful tool for generating revenue for purposes that exceed the community's ability to raise property taxes. These purposes have traditionally been major capital projects that are of critical importance and affect the vitality of a region greater than just the community imposing the tax. An example is the flood control project for which the original local sales tax in Rochester was authorized*."

However, as that report also noted, the threshold for "regional benefit" is quite subjective and difficult to define. Minneapolis is the largest city in Minnesota and its roads in many portions of the city are used heavily by non-residents. Does that make roads in Minneapolis, or almost any expense in either of the Twin Cities, a regional benefit?

"Regional benefit" means different things in different areas of the state. A city of 5,000 in the Twin Cities metro would appear unlikely to offer a local sales tax proposal with a clear regional benefit, but it would not be uncommon in many parts of Greater Minnesota.

One way of trying to make "regional benefit" more objective is by assessing whether non-residents will make as great a use of the project as city residents will. Sometimes this can be measured and sometimes it cannot, but if legislators choose to endorse this standard they can ask cities to demonstrate the extent to which non-residents will benefit, and how it compares to how much they will pay.

Greater weight given to multi-jurisdictional compacts

Another way of assessing whether or not a project has regional benefit is whether voters outside the jurisdiction where the project is located would vote in its favor. While not every deserving project would be able to be on the ballot in multiple jurisdictions, it would indicate broader support for the use of revenue and its regional benefit.

There are other standards that the Property Tax Division could consider when measuring local sales tax proposals, such as whether or not a jurisdiction has significant amounts of exempt property, ability to raise sales tax revenue, existing local sales and property tax rates in the jurisdiction, if the use of revenue is normally funded by the property tax, if the local businesses are supportive of the tax, and more. The standards discussed above in this memo are the criteria that have drawn the most discussion in recent years.

Safe harbor list of approvable projects

The criteria for approving and disapproving of local sales taxes should be more transparent. Local governments invest significant time and resources in these proposals before they go to the legislature or ballot. Even when a set of standards are applied by legislators it's not always clear that was the case. So the committee may want to consider a "safe harbor" list of sorts. A list of types of projects that, while they would still need to go through the formal legislative and ballot approval process, would have a less significant review process at the Capitol.

The following list is not a proposed list of presumably approvable "safe harbor" projects, but rather the beginning of a discussion for members of the division to consider:

- Convention and Civic centers
- Airports
- Recreational centers that serve non-residents
- County jails
- Athletic complexes that host tournaments or other events that draw significantly from outside the jurisdiction
- Regional libraries
- Parks that draw more visitors than other parks in surrounding jurisdictions
- Aquatic facilities that draw more visitors than other aquatic facilities in surrounding jurisdictions

- Hospitals

Members of the division may determine that there are other types of projects that generally meet the criteria for local sales taxes as well. Or there may be some types of projects on this list that members of the division feel do not meet that general criteria. This is only a starting point. Regardless, the goal should be for the division to set some list to establish more predictability in this process.

Below is one set of questions that would be helpful in assessing any local sales tax proposal. I welcome the committee's additional input in how to best evaluate these proposals.

1. Is this a capital project?
2. Does the project provide a clear regional benefit?
3. Is it known what percentage of the tax will be paid directly by non-residents?
4. Is it known what percentage of the people directly using the benefit will be non-residents?
5. Why is a local sales tax the best revenue source for this project?
6. Are these projects clearly separated?
7. If implemented, including the county, city, and state sales tax, how high would the sales tax rate be in this jurisdiction?
8. What year will this proposal go before the voters?
9. Is the jurisdiction using this tax to generate the local match for a bonding proposal?
10. Does the local sales tax have a clear end date?

Conclusion

Local sales taxes can play an important role in providing funding for projects that may not otherwise come to fruition. They can ensure that certain communities that provide services and infrastructure for other communities are able to maintain an appropriate balance between who pays and who receives the benefits of projects. At the same time the legislature has always had a role to play in deciding whether local sales tax proposals meet the criteria set in statute. The goal for the Property Tax Division should be to determine what standards we should measure these proposals by and do so in a way that is clear and transparent to the public.