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Minnesota House of Representatives

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TO: Members of the Tax Committee

FROM: Pat Dalton, Legislative Analyst
Steve Hinze, Legislative Analyst
Joel Michael, Legislative Analyst

RE: State Auditor's data on local government revenues and expenditures

You requested information on the local government revenue and expenditure data collected by the state auditor's office and its suitability for use in constructing local government aid formulas and calculating local government aid cuts.

Overview

The Office of the State Auditor's (OSA) data provides a useful and generally reliable source of state level data on the revenues and spending of local governments. However, the data has some limitations, particularly for use in determining aid (or aid cuts) for individual cities or counties. These limitations arise mainly from the fact that OSA data is prepared and collected for financial reporting purposes, not for tax and aid administration or research purposes. Generally accepted accounting principles (or GAAP) allow local governments flexibility in how they set up their accounts and report information. Also, local governments manage and pay for local services in somewhat different ways, depending upon their size and regional location.

There are four principal limitations to using largely unadjusted OSA data to determine the amount of a city or county's state aid:

- **Local governments vary considerably in the extent to which they report functions in governmental versus enterprise funds.** For example, many units report parks and recreation, transit, and housing and economic development functions in governmental funds, while many others do so in enterprise funds.
- **Intergovernmental cooperation agreements (where one unit provides the service under contract to another) lead to double counting of revenues in the aggregate and faulty conclusions regarding spending and revenues for individual jurisdictions.** The OSA data appropriately includes payments by one local jurisdiction to another to provide services

to residents in the first jurisdiction. It is unclear how completely this effect is eliminated by the adjustments proposed by the administration.

- **Some services are provided by different governmental units (cities, counties, and special districts) in different parts of the state.** As a result, revenue patterns will also vary depending upon the basket of services the unit of government provides.
- **Revenues and expenditures fluctuate from year-to-year for individual units based on unique circumstances.** An individual unit may receive a large grant or refund or make a large capital expenditure. For smaller units of government this can lead to very large variations over time.

Discussion

In 1991, the Ladd study¹ analyzed city aid need in Minnesota using the state auditor spending data. One of the major tasks of the staff that worked on the study was to “clean” the state auditor data so it was suitable to use in the analysis. Much of the following discussion on data limitations is based on the work done during that period. Some of the problems identified had little impact on the Ladd analysis because the study was attempting to develop general measures of city spending need rather than analyze spending levels in individual cities. Although that study used spending data, the same limitations apply to the revenue data.

The State Auditor’s Local Government Fiscal Data

The state auditor is required by law to collect revenue and expenditure information from all cities, counties, and other local units of governments and issue summary reports on this data every year.² The state auditor collects local government financial information for two primary reasons:

- To ensure that local governments are fiscally solvent; and
- To ensure that revenues are collected and expenditures made in compliance with law.

The OSA data is the most complete and consistent source of statewide information on local government finances available on an annual basis. The data are widely used as a source of information on the local government spending and revenues; indeed the data are the only real comprehensive statewide source of this information. Although this memorandum points out inconsistencies in the way economically equivalent information is reported by individual cities, the data are still a reliable source of information on the overall spending and revenue patterns of local governments. Certain inconsistencies and anomalies in the reported data may “wash out” or offset each other when the data are used to assess the overall fiscal conditions of all cities and counties, but caution should be taken when using this data for determining aid payments or cuts to individual cities or counties. A number of the limitations described below stem from the fact that the data is collected for auditing rather than analysis purposes and the information is reported by fund type rather than by service function.

¹ Measuring the Fiscal Conditions of Cities in Minnesota: Final Report to the Minnesota Legislative Commission on Planning and Fiscal Policy; Helen Ladd, Andrew Reschovsky, and John Yinger; March 1991

² Minn. Stat. §§ 6.74 and 6.75.

Data Limitations

The reporting of governmental funds and propriety funds separately underestimates revenues and spending in functional areas for certain cities. GAAP gives local units flexibility in deciding whether to account for certain functions in either “governmental” funds or “enterprise” funds. For management or other reasons, local units make a variety of choices in this regard. Thus, two units may report revenues and expenditures for the same functions in two different types of funds.

Governmental funds consist of General, Special Revenue, Capital Projects, and Debt Service Funds. The proprietary or public service enterprise funds consist of a variety of services provided by local government that are operated solely or in part with revenues derived from the sale of the services or goods. In addition to the services that we generally think of as public enterprise services such as public utilities and municipal liquor stores, many cities choose to provide what we might consider as “general” governmental services such as street sweeping or parks in enterprise funds.

A number of governmental services, such as economic development, ambulances, and transit, are included in governmental funds in some cities and in enterprise funds in other cities. In addition, there are instances when a service should be reported in an enterprise fund but is not. On occasion the state auditor has required a city to change reporting methods for a specific service (Spirit Mountain in Duluth is an example), but this has not been common.

During the Ladd Study, individual city governmental funds spending data was adjusted to exclude spending that was typically provided in enterprise funds and to include data from enterprise funds that was typically reported in governmental funds. Although revenue data from selected enterprise funds can be added to governmental fund data, it is harder to exclude revenue attributed to services that should be reported in enterprise funds.

The following table gives an indication of the relative magnitude of the problem:

Comparison of 2000 Current Expenditures for Selected Services Reported in Governmental Funds versus Public Service Enterprise Funds Cities with Population of 2,500 or more (\$ millions)		
Service Area	Governmental Funds	Enterprise Funds
Streets	\$263.2	\$14.9
Parks and Recreation	\$233.4	\$101.2
Transit	\$13.8	\$12.5
Housing and Economic Development	\$184.8	\$54.2

Intergovernmental service cooperation leads to double counting of revenues and expenditures in the aggregate and faulty conclusions of revenues and expenditures at the individual jurisdictional level. Cities and counties pay each other to provide governmental services. Towns and smaller cities often pay counties or larger cities to provide public safety and

road services. Local governments may enter into joint powers agreements where one unit provides all of one type of service, i.e., fire or libraries, for several municipalities. The revenues and expenditures for these services are counted twice—first in the entity purchasing the service, and second in the entity providing the service. It is not always possible to segregate costs and revenues between those associated with provision of services to residents versus nonresidents.

We do not have an estimate regarding the amount of double counting resulting from intergovernmental cooperation, but studies over the years indicate that this is an important and growing phenomenon in providing government services. The Department of Revenue attempts to correct for this problem in the governor's caps on aid cuts by removing local government grants from the definition of revenue. This probably accounts for much of these payments; however, some of these intergovernmental payments may be included in service charges and fees for specific areas. These fees and charges would be impossible to identify and separate from other user fees in the OSA data. The Ladd study dealt with this issue by only looking at city spending net of user fees.

Not all services are provided by the same level of government in all areas of the state. As cities have been quick to point out, counties and regional government provide a number of services in the metro area that cities provide in Greater Minnesota. This leads to certain cities having higher revenue and spending than other cities simply because they provide more types of service. Whether the different service levels should be considered and adjusted for in determining a city's ability to absorb an aid cut is a policy decision. Similar considerations probably should be taken into account in cutting aids to counties and other local governments as well.

In any given year, revenue and expenditure data may be unusually high or low for specific cities due to unique circumstances. Cities and counties can often experience a one-time sharp deviation in the revenues or expenditures due to one-time events. A flood may lead to a temporary increase in federal and state grants for one year; an adjustment in pension calculations may lead to a large one-time refund.

Most of the fluctuation in spending occurs in capital outlays, and not in operating expenditures. To adjust for the spending fluctuations in the Ladd database, spending was defined as current (operating) expenditures plus a four-year average of capital expenditures. Absent a careful examination of individual audit reports, it is difficult to determine and adjust for one-time anomalies in expenditures. The identified anomalies in the 2000 auditor's revenue data for individual cities will disappear when 2001 auditor data is available, but they will be replaced with new anomalies.

Conclusion

If the legislature wants to measure or limit the impacts of aid cuts on the budgets of individual local governments, the auditor's data provides the most comprehensive and objective measure of local government budgets. However, the unadjusted revenues and expenditures in the governmental funds report are not totally consistent among individual cities and counties. Care should be taken when using these numbers in aid and aid cut formulas.