

## **LOCAL OPTION AND REGIONAL SALES TAX BACKGROUND**

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Minnesota law prohibits the imposition of any local sales tax without specific legislative authorization. At present, 23 local governments exercised the authority given to them by the Legislature. They are Albert Lea, Austin, Baxter, Bemidji, Brainerd, Cook County, Duluth, Hermantown, Mankato, Minneapolis, New Ulm, North Mankato, Owatonna, Proctor, Rochester, the St. Cloud area (St. Cloud, St. Joseph, Sartell, Sauk Rapids and Waite Park), St. Paul, Two Harbors and Willmar. In addition, the cities of Clearwater, Emily and Rockford voted locally to authorize a local sales tax but need legislative approval to implement one and the city of Worthington has until the 2008 general election to seek voter approval for a local sales tax. Willmar and Winona are the only communities that had local sales tax authority, exercised it for a period of time, and allowed the tax to sunset for at least one year before seeking new authority.

Local and regional sales taxes are a statewide issue because they reduce accountability, are difficult for businesses to administer, exacerbate tax base disparities, delay sales tax reform, put upward pressure on the property tax and complicate the electronic commerce debate.

- **Reduces accountability.** Expanding the use of local or regional sales taxes reduces accountability of the local revenue system. The sales tax gives a local government the ability to tax people who don't vote in their community.
- **Difficult to administer.** Businesses, especially small businesses, have difficulty administering local sales taxes because they must determine where a product will be used and if that location is within the boundaries of a local government having a local sales tax. Some have tried to use the purchaser's zip code; however, in many cases zip codes do not correspond to municipal boundaries. The 1999 Legislature passed a provision that prohibits retailers from using zip codes to determine whether to impose a local sales tax unless the zip code area is entirely within the city's boundary. (If the Streamlined Sales Tax Project (SSTP) is able to radically simplify the sales tax and the SSTP's recommendations are adopted by most states, the administrative burden could be lessened. For more information about the SSTP, see the Chamber's Sales & Use Tax policy.)
- **Exacerbates tax base disparities.** Retail sales are not evenly distributed among Minnesota cities. Some have much larger sales tax bases than others. Expanding the use of local or regional sales taxes could lead to a new state aid program to equalize their yield. A new state aid program for local governments should not be a priority for any revenue that is available.
- **Delays sales tax reform.** Expanding the use of local or regional sales taxes could delay sales tax reform. If more local governments rely on the sales tax to finance government projects, it will be more difficult for the Legislature to reform the sales tax base as has been recommended by the Sales Tax Advisory Council (1995 and 1996). For example, if more business inputs are removed from the sales tax base, local governments will have less revenue available to pay off projects. This could cause local officials to lobby against any such sales tax base changes. There would also be an incentive for local officials to support broadening the sales tax base because it would provide communities with greater revenue.
- **Puts upward pressure on the property tax.** The proceeds from the most recent local sales taxes approved by the Legislature were dedicated primarily to construction projects - i.e. convention and civic centers, etc. In most cases, local sales tax revenue cannot be used for operating purposes. Therefore, local governments will likely look to the property

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tax as the source of operating funds which could increase the growth rate of the property tax.

- **Complicates the electronic commerce debate.** Multistate businesses already face a significant burden administering the sales and use tax. Requiring businesses to collect the sales tax on remote sales exacerbates this burden because the nation has more than 7,000 taxing jurisdictions. These jurisdictions not only have their own sales tax rates, but many also have different sales tax bases. Compounding this problem is the fact that many local sales tax rates cross zip-code boundaries, making it difficult for businesses to determine if a local sales tax applies. (If the Streamlined Sales Tax Project (SSTP) is able to radically simplify the sales tax and the SSTP's recommendations are adopted by most states, the administrative burden could be lessened. For more information about the SSTP, see the Chamber's Sales & Use Tax policy.)

Local sales tax authority was among the topics debated by the 1995 and 1996 Sales Tax Advisory Council. In its report to the 1997 Legislature, the council recommended that general authority for local sales taxes not be granted and that the Legislature "exercise restraint" in granting new authority to individual local governments. The report also recommended that: (1) the local sales tax must follow the state sales tax base; (2) all state exemptions apply to local taxes; and (3) all local taxes must be administered by the Department of Revenue. These recommendations were adopted by the Legislature.

In 1999, the Legislature codified four of the Minnesota Chamber's five conditions for granting local sales tax authority. Future grants of local sales tax authority are required to be approved at a general election, dedicated for a specific capital improvement project, and terminated after the project is completed. In addition, after the local sales tax expires, the community is prohibited from seeking additional authority for at least one year. The Legislature did not enact the Chamber's suggestion that local communities seeking sales tax authority commit to arrange at least 50 percent of the cost of the project with other revenues. This recommendation addresses the accountability problem by requiring local communities to demonstrate that the project is supported locally. For example, the other revenue could come from property taxes or spending reductions. It also allows local communities to show that the project is supported at the state or national level by securing state or federal grants.

In 2003, the Legislature asked the Department of Revenue to study local sales taxes and make recommendations on the appropriate role of local sales taxes, criteria for evaluating local sales tax proposals, and the feasibility of authorizing the commissioner of revenue to approve or deny local sales tax proposals based on a uniform set of criteria. The department also was asked to report on the compatibility of local sales taxes with the streamlined sales tax project and the ability of jurisdictions to raise revenue by other means among other things.

The department identified nine policy issues with respect to local sales taxes, including local accountability, potential local government opposition to sales tax base reform, administrative and compliance costs, and tax base disparities. With respect to tax base disparities, the department found that the distribution of the sales tax base is more uneven than the distribution of the property tax base. The department also found that a 0.5-percent rate increase typically causes a 1.5-percent to 5.0-percent loss in gross sales.

The study had five recommendations for the Legislature. First, local sales tax authority should be limited to financing specific projects rather than operating purposes. Second, criteria should

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be developed to limit the use of local sales taxes to extraordinary capital projects having regional impact. Third, a regional vote should be conducted for approval of a local sales tax. Fourth, the strength of a community's tax base should be considered when evaluating a local sales tax proposal. Fifth, legislative approval should continue to be required.