



Michigan COMMENTARY

UPDATE ON SCHOOL FINANCE REFORM

by Robert J. Kleine

School finance reform, which had been moving slowly through the legislative process, ran into a roadblock in the House on April 26. Both the plan supported by House Democrats and the Governor and a House Republican alternative failed to win the necessary two-thirds approval; the Democratic plan was rejected by a 60-47 vote (73 votes are needed for passage). The major areas of disagreement concerned how much property tax relief businesses should receive, how large a tax increase is acceptable, and whether the proposal should be on the ballot in August or November. The House approved an amendment to the plan that would constitutionally prohibit a sales tax on services, but this is unlikely to be acceptable to most Democrats when, and if, a final plan is passed. The distribution of revenues to K-12 districts is another controversial area that has not been addressed.

School finance reform is a very fluid issue, and negotiations will be continuing over the next few weeks. Many of the points of disagreement will be difficult to resolve, particularly since a number of legislators have serious doubts about the ability of any proposal to win voter approval.

Background

Funding for K-12 education is shared by local governments and the state, with a small amount of aid provided by the federal government. In FY 1987-88 the state provided \$2.7 billion, and local school districts raised about \$3.9 billion from the property tax. The state share of 40 percent is up from a low of 32.6 percent in FY 1981-82. In FY 1978-79, however, prior to the beginning of Michigan's severe fiscal problems, state government's share was 45.1 percent; the highest support in the past two decades was 51.9 percent in FY 1966-67.

About two-thirds of state aid to school districts is distributed through the school aid formula, which is based on the "power equalizing" concept; that is, the state attempts to equalize the resources of school districts because the property tax base per pupil varies widely among districts. For example, in Detroit the property tax base per pupil is \$27,081, compared with \$209,509 in Birmingham (1987-88 data). This means that in Detroit one mill raises only \$27.08 per pupil, while in Birmingham one mill raises \$209.51 per pupil.

The 1987-88 school aid formula guarantees school districts \$350 plus \$75.10 per mill per pupil. The grant from state government is equal to the guarantee less the amount of revenue raised locally. For example, a school district levying 30 mills would be guaranteed \$2,598 per pupil. If that school district raised \$1,500 per pupil locally, it would receive a state payment of \$1,098 per pupil. There are 153 "out-of-formula" districts, or 27 percent of all districts, that raise more locally than the guarantee and therefore receive no state aid from the formula. In-formula districts will

receive additional state aid if the millage rate is increased, but increases in the property tax base result in offsetting reductions in state aid.

The remainder of state aid to school districts is in the form of categorical grants, such as for transportation, special education, and social security. The state also pays the contributions to the school employees' retirement fund.

Michigan's school finance system has some serious weaknesses. It leaves large revenue disparities among districts, resulting in low quality education in many; it leads to a substantial number of out-of-formula districts; and it encourages excessive local reliance on the property tax because state aid depends in part on local tax effort. As indicated in Exhibit 1, about 12 percent of the students are in districts that spend \$2,600 or less per pupil, and 18.8 percent of the students are in districts that spend \$3,500 or more per pupil. The dramatic differences between out-of-formula and in-formula districts can be seen in exhibits 2 and 3. In FY 1987-88 in-formula districts spent an average of \$2,753 per pupil and levied an average of 22 mills, while out-of-formula districts spent an average of \$3,908 per pupil and levied an average of only 27.4 mills. This large disparity is explained by the average state equalized valuation (SEV) per pupil of \$52,678 in in-formula districts and \$174,116 in out-of-formula districts. The difference is too large for the state school aid formula to equalize without a significant increase in funding. To bring spending per pupil in in-formula districts up to the level of spending in out-of-formula districts would cost about \$1.5 billion.

The large number of out-of-formula districts indicates that many Michigan voters want more education than can be supported by state funds, which means even greater reliance on property taxes because school districts have few revenue alternatives. Only five states raise a larger percentage of K-12

EXHIBIT 1

SELECTED CHARACTERISTICS OF MICHIGAN SCHOOL DISTRICTS, FY 1987-88

<u>Revenue Level</u>	<u>Average Revenue per Pupil</u>	<u>Number of Districts</u>	<u>Percentage of Students</u>	<u>Average Size (number of students)</u>	<u>Average SEV/pupil</u>	<u>Average Operating Millage</u>
\$ 0 - 2,300	\$2,116	31	1.4	735	\$79,139	22.4
2,300.01 - 2,600	2,453	125	11.0	1,454	55,997	27.7
2,600.01 - 2,900	2,741	170	20.9	2,035	57,825	31.1
2,900.01 - 3,200	3,035	113	38.6	5,666	62,635	34.7
3,200.01 - 3,500	3,335	43	9.4	3,644	81,105	35.9
3,500.01 - 3,800	3,630	25	7.0	4,649	109,642	33.5
3,800.01 - 4,100	3,920	14	2.0	2,348	161,552	28.5
4,100.01 +	6,100	42	9.8	3,858	318,731	27.6
TOTAL	\$3,067	563	100.0	2,947	\$85,680	30.7

TOTAL NUMBER OF STUDENTS: 1,659,117

SOURCE: Michigan Department of Education.

EXHIBIT 2

SELECTED CHARACTERISTICS OF MICHIGAN IN-FORMULA
SCHOOL DISTRICTS, FY 1987-88

<u>Revenue Level</u>	<u>Average Revenue per Pupil</u>	<u>Number of Districts</u>	<u>Percentage of Students</u>	<u>Average Size (number of students)</u>	<u>Average SEV/pupil</u>	<u>Average Operating Millage</u>
\$ 0 - 2,300	\$2,161	21	1.4	872	\$61,942	24.1
2,300.01 - 2,600	2,452	112	12.9	1,510	50,834	28.0
2,600.01 - 2,900	2,737	147	23.3	2,071	50,239	31.8
2,900.01 - 3,200	3,035	96	46.9	6,380	54,495	35.8
3,200.01 - 3,500	3,328	28	102	4,744	59,103	39.7
3,500.01 - 3,800	3,612	6	5.4	11,681	55,378	43.4
3,800.01 - 4,100	0	0	0	0	0	0
4,100.01 +	0	0	0	0	0	0
TOTAL	\$2,753	410	100.0	3,188	\$52,678	32.0

TOTAL NUMBER OF STUDENTS: 1,307,253

SOURCE: Michigan Department of Education.

EXHIBIT 3

SELECTED CHARACTERISTICS OF MICHIGAN OUT-OF-FORMULA
SCHOOL DISTRICTS, FY 1987-88

<u>Revenue Level</u>	<u>Average Revenue per Pupil</u>	<u>Number of Districts</u>	<u>Percentage of Students</u>	<u>Average size (number of students)</u>	<u>Average SEV/pupil</u>	<u>Average Operating Millage</u>
\$ 0 - 2,300	\$2,022	10	1.4	502	\$115,253	18.7
2,300.01 - 2,600	2,464	13	3.6	973	100,475	24.7
2,600.01 - 2,900	2,769	23	11.8	1,805	106,306	26.7
2,900.01 - 3,200	3,036	17	7.9	1,633	108,602	28.9
3,200.01 - 3,500	3,349	15	6.8	1,592	122,177	29.0
3,500.01 - 3,800	3,636	19	13.1	2,428	126,777	30.4
3,800.01 - 4,100	3,921	14	9.3	2,348	161,552	28.5
4,100.01 +	6,100	42	46.1	3,858	318,731	27.6
TOTAL	\$3,908	153	100.0	2,300	\$174,116	27.4

TOTAL NUMBER OF STUDENTS: 351,864

SOURCE: Michigan Department of Education.

school funds from local sources than does Michigan, which raises about 60 percent locally, compared to a national average of 47 percent.

School finance reform has been an important issue in Michigan for two decades. A 1968 study by the legislature and the state Department of Education concluded that heavy reliance on local property taxes widened the gap in educational opportunities among school districts. A statewide property tax was recommended, but no action was taken.

In 1971 Governor Milliken presented a plan to the legislature that would have reduced reliance on local property taxes for schools and increased reliance on the state income tax and a business value-added tax. (The single business tax, a type of value-added tax, was enacted in 1976, but the revenues were not used for schools.) This proposal generated considerable interest but failed to win legislative approval.

Over the next decade the voters were given seven opportunities to change constitutionally the method of financing schools and/or reduce property taxes, but as indicated in Exhibit 4 all seven proposals were soundly defeated.

EXHIBIT 4

PROPOSED AMENDMENTS TO STATE CONSTITUTION: SCHOOL FINANCE REFORM AND PROPERTY TAXES

<u>Proposal</u>	<u>Date</u>	<u>Percentage For</u>	<u>Percentage Against</u>
School finance reform (increase income tax)	November 1972	42.2%	57.8%
School voucher plan	November 1978	25.7	74.3
Reduce property taxes (Tisch)	November 1978	37.3	62.7
Reduce property taxes (Tisch)	November 1980	44.2	55.8
School finance reform (Smith-Bullard)	November 1980	21.2	78.8
Reduce property taxes and raise sales taxes	November 1980	25.7	74.3
Reduce property taxes and raise sales tax	May 1981	27.9	72.1

SOURCE: State of Michigan, Michigan Manual, 1987-88.

Current Proposals

The Senate passed a resolution in March to place a school finance proposal on the ballot, and the Governor and House Democrats recently agreed on an alternate proposal, which failed to win House approval on April 26.

Both plans propose to raise the sales tax from 4 percent to 6 percent, but the other provisions differ considerably. The Senate proposal reduces the property assessment ratio from 50 percent to 35 percent for commercial and industrial property and to 25 percent for residential and agricultural property, while the House plan provides a \$15,000 SEV exemption for all property. The House also proposes to raise \$120 million by increasing taxes on banks, insurance companies, savings institutions, lottery winnings, military personnel, and others (also known as closing loopholes). The House plan also includes relief for renters and for utility taxes paid by low-income persons.

The Senate plan earmarks 12 percent of the state general fund for the school aid fund, while the House plan earmarks 24 percent of the two-cent sales tax increase, the beer and wine tax, an additional 18 cents per pack of the cigarette tax, an additional 4 percent of the liquor tax, and the use tax.

As indicated in Exhibit 5, the Senate plan results in a net increase in tax revenues of about \$130 million; the House plan raises \$620 million, with the additional funds to be used for K-12 education. Neither specifies how the new money is to be distributed.

The most controversial differences between the two plans are as follows:

- The House plan provides a 44 percent property tax reduction (before loss of circuit-breaker credits) for homeowners and 12 percent for businesses. The Senate plan reduces property taxes by 50 percent for homeowners and 35 percent for businesses. The business community strongly opposes the House plan.
- The business community and others oppose the House plan because of the large tax increase and the "loophole" closing package.
- The Senate proposes a November vote, while the House wants the proposal on the August primary ballot. The proposal probably will have a better chance of passing with the larger November turnout, but Democrats are concerned that the issue could cost a few votes, and the presidential election is expected to be very close.
- The House plan is more beneficial to homes of low value than of high value. For example, the Senate proposal provides a 50 percent reduction for all homeowners, while the House plan provides a 50 percent or larger reduction only for homes with an SEV of \$30,000 or below; a home with an SEV of \$60,000 receives a 25 percent reduction.

Comment

Successful school finance reform would ensure equal access to quality education across the state and would provide adequate school operating revenue now and in the future, reducing reliance on the local property tax. A school finance plan meeting the following criteria would achieve the goals of successful reform. The first three criteria are essential: The plan must provide a more equal distribution of revenue, meet the limitation requirements of the constitution, and be politically feasible. Five other criteria are probably necessary if a reform plan is to win sufficient political support: It must provide property tax relief, reduce reliance on property taxes, establish minimum standards of quality, maintain local control, and allow local enhancement of educational programs (through extra voted millage). The

EXHIBIT 5

COMPARISON OF PROPERTY TAX/SCHOOL FINANCE PROPOSALS

	Senate Joint Resolution K (as passed Senate)	Governor Blanchard/ House Democratic Proposal
Tax increases:		
Raise sales tax from 4 percent to 6 percent	\$1,560 million	\$1,560 million
Raise taxes on banks, insurance companies, savings institutions lottery winnings, military personnel, and others	None	\$120 million
Total tax increases	\$1,560 million	\$1,680 million
Tax relief:		
Business property tax relief	\$409 million	\$100 million
Residential property tax relief	\$1,021 million	\$860 million
Renter relief and low-income utility relief	None	\$100 million
Total tax relief	\$1,430 million	\$1,060 million
Increase in taxes minus total tax relief	+\$130 million	+\$620 million
Other considerations:		
Constitutional cap on local property taxes	No	No
Constitutional ban on expansion of the sales tax to services	No	Yes (as amended)
Updates constitutional tax limit to prevent further increases in state taxes and spending	No	No
To be placed on the ballot [*]	November 1988	August 1988
Status	Passed Senate with bipartisan majority on March 16, 1988. Referred to House Taxation Committee.	Presented as alternative to SJR K on April 11, 1988. Defeated on House Floor.

* Placement on the ballot requires a two-thirds majority of both houses (26 votes in the Senate and 73 in the House). The Governor cannot veto such a measure.

final two criteria are desirable but not essential; a plan should improve the progressivity of the tax system and maintain or improve its stability.

Although there appears to be widespread agreement that the current system is flawed, a fairer school finance system may not be enough to carry a proposal to victory. Experience suggests that Michigan voters are unlikely to approve any reform that alters the tax structure. They appear to prefer the known devil to the unknown devil; since 1972 voters have rejected nine of ten proposals to cut, shift, limit, or otherwise alter taxes. Most of the rejected proposals would have shifted the tax burden from the property tax to the state sales tax. (The constitution limits the sales tax rate to 4 percent.) The latter, a productive revenue source, is underutilized in Michigan compared with other states, and raising the sales tax would be less unpopular than increasing other major taxes. Voters have consistently defeated tax shift proposals because they do not trust government. They fear that any property tax relief they may receive will be taken away, leaving them without relief and with a higher sales or income tax.

A 1987 poll commissioned by the House Republican Task Force on Property Tax and School Finance Reform reaffirms the public's opposition to a shift from the property tax to other taxes. A uniform statewide property tax was the most popular alternative revenue source, but opposition exceeded support by two percentage points. The poll indicated that the most unpopular revenue source was the local sales tax, which was opposed by 68 percent of those surveyed and supported by only 26 percent. A state sales tax, a local income tax, a sales tax on services, and a state income tax increase were also opposed by large margins.

It is not yet clear whether a school finance reform plan will be on the ballot in August or November. If there is a proposal, it is likely that the voters will reject the plan. This will not make the problem go away. The legislature will almost certainly have to pursue a statutory solution, which could involve an increase in the state income tax. If the ballot proposal fails, we would like to see a plan to reduce school millage rates gradually over a ten-year period, increase state support for education to 50 percent, and raise needed revenue by modest increases in the income tax and single business tax and by an extension of the sales tax to services, and/or by authorizing a local school district income tax.