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Public Sector Reports

Michigan **COMMENTARY**

Exploring the Unknown: A New Approach to School Finance Reform

by Robert Kleine, Vice President and Senior Economist

In late July the Michigan Legislature, in an unprecedented action, took a step into the unknown: It repealed school operating property taxes without enacting replacement revenue. This may be a foolhardy action borne out of mass hysteria, or it may prove to be a brilliant move that leads finally to a break in the more than 20-year impasse on school finance reform. One view is that the legislature's action was courageous, that tinkering with the old system wasn't working, and that a crisis had to be created to get the problem fixed. Another is that the legislation simply heads off future court action that will declare Michigan's method of financing schools unconstitutional. One other view is that the action makes no sense, and that it is in fact dangerous to eliminate school property taxes without enacting a plan to replace the revenue and distribute the money. A key question concerns the breadth of reform: Will only money be discussed, or is the door also open to such reform issues as schools of choice, statewide teacher bargaining, vouchers, district consolidation, and teacher tenure? Advocates and opponents of such reforms could complicate the debate about replacement revenue.

There are many unknowns and many possible outcomes, but some initial observations can be made. This paper examines some of the possible implications of the legislature's bold decision and presents options for replacing the school property tax, for distributing the replacement funds, and for reforming our system of education.

PROVISIONS OF SENATE BILL 1

The legislation that repeals school operating taxes, Senate Bill (SB) 1, includes four significant provisions. Although the governor has not yet signed the bill, he has indicated that he will. (At that time it will be given a public act number.)

- Beginning December 31, 1993, all property is exempt from local school district and intermediate school district (ISD) operating millage. This eliminates local school funding for 1994–95. Debt and possibly building and site millages are not affected by the repeal, and community colleges are specifically exempt.

- Beginning in 1994 the assessment on which taxes are levied is delayed by one year. That is, the 1994 levy will be based on assessments as of December 31, 1992, rather than December 31, 1993. The effect will be to freeze assessments in 1994, and the purpose of this change is to give taxpayers additional time to appeal them.

- The ballot requirements for millage elections are changed to allow no more than two annually, to require that millage renewal and increase questions be separate, and to require that the ballot state the amount of revenue to be raised by the millage.

- Local governments are no longer allowed to automatically roll up "Headlee" millage rates. Currently, millage rates rolled back under Article IX, Section 31, of the state constitution can be increased without voter approval in years when assessments increase less than the rate of inflation. Beginning in 1994 the millage reductions required by the constitution will permanently reduce the maximum authorized millage rates. Also, Headlee override votes must be presented to the electorate as millage increases.

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FISCAL IMPACT

As shown in Exhibit 1, the effect of the legislature's action will be to decrease property taxes by about $6.8 billion annually (in current dollars), about $6 billion of which would have been allocated for K–12 operating purposes. Because this reduction in property taxes also will reduce state-funded homestead credits by about $800 million, the net cut is about $6 billion. This includes about $200 million in property tax revenue currently collected by the state: utility property taxes and special levies under Public Act 198 to partially replace local property taxes exempted under the industrial tax abatement program. In addition, the 1994 assessment freeze, or lag, will reduce property taxes for other local units of government by about $150 million. We assume these latter revenues will not be replaced.

Exhibit 1

Fiscal Effect of Senate Bill 1 in 1994
(dollars in millions)

Estimated SEV (December 31, 1993)	$178,000
School operating millage rate (1993)	33.8
Tax reduction	$6,016
ISD operating tax	$550
Specific tax (PA 198)	180
State utility property tax	100
Gross property tax reduction	$6,846
State homestead tax credit	-$800
Net property tax reduction	$6,046
Net residential/agricultural reduction	$3,468
Net business tax reduction	2,578
1994 freeze/other local units	$150
Addendum: Tax yields (FY 1994–95)	
Property tax (1 mill)	$178
Income tax (1 percent)	1,300
Sales and use taxes (1 percent)	925
Single business tax (1 percent)	900

SOURCE: House Taxation Committee and Public Sector Consultants, Inc.

Property taxes collected from individuals will be reduced about $3.5 million (net of credits), and taxes paid by businesses will be reduced about $2.6 billion.

IMPLICATIONS

The repeal of school property taxes will have myriad implications for the state budget, school districts, businesses, property values, homeowners and renters, and the state economy, but not many can be predicted with certainty at this time.

In the short run, great uncertainty has been created for school districts, in bond ratings, and for economic development districts created under tax increment finance authorities (TIFAs). School districts with millage votes are confused about the new ballot requirements, which may require some clarifying legislation. The initial reaction on Wall Street was great concern, and it is unlikely that any non–general obligation bonds issued by school districts or the state will receive ratings until replacement sources of revenue are approved. TIFA districts have lost about 65 percent of their revenue, which raises questions about bond payments and puts many economic development projects in limbo. In all previous property tax reduction proposals, tax increment financing was protected, and this is likely to be the case now, too, but the approach to be used is uncertain. The state may have to make direct grants to TIFAs or find a new revenue source for them. The TIFA law may be repealed and a new method for financing local economic development projects enacted.

School Districts

Under any new system there will be winners and losers. The winners in this case are likely to be low-spending school districts in rural areas and small towns, because the new financing system likely will include a foundation grant along the line of that included in Proposal A on the June 1993 ballot. The losers will be the high-spending school districts in areas such as Oakland County. The question is whether the state will guarantee the current level of spending and/or allow a local revenue option such as an income, sales, or property tax. We do not expect the state to continue to allow the current spending disparities. One approach would be to freeze all high-spending districts at the FY 1993–94 level until the foundation grant catches up.

Another would be to provide every district with a foundation grant and allow the high-spending districts to levy (with local voter approval) a local property or income tax but impose some limit on their growth.

One possible consequence is that school districts in total will be required to reduce expenditures, possibly by as much as 5 to 10 percent. This may be accompanied by incentives or requirements for district consolidation. There also could be changes in the level at which teacher contract bargaining occurs—regional or statewide instead of local—and some limits imposed on the pay of teachers and other school employees. There almost certainly will be a strong push to allow schools of choice, a concept supported by Governor Engler, in order to foster competition among schools and encourage more efficient operation.

Taxpayers

Most taxpayers likely will end up with a net tax cut, but it is difficult to sort out winners and losers until we know how the lost revenue will be replaced. It is clear, however, than most property owners will be winners, and renters will be losers. Taxpayers not currently receiving the homestead tax credit, generally those with income above $83,000, could be the biggest winners because they generally pay high property taxes and do not have the credit to lose. However, if the income tax is used to replace a major share of the property tax, these same taxpayers could end up paying higher taxes. Exhibit 2 presents several examples of the effect on high-income taxpayers, assuming (1) the approval of a 1.3 percent increase in the personal income tax and a 17-mill statewide property tax, which would replace 90 percent of the lost revenue, (2) that the revenue lost from individuals and business will be fully replaced, and (3) that under the constitutional limit only about $3.2 billion can be raised in additional state taxes (excluding a statewide property tax). For a taxpayer with a home valued at $150,000 (and assessed at $75,000) and a 40-mill school tax rate, the break-even income level is $141,000. That is, people earning more than $141,000 will pay more than they do under the old tax system, and those earning less than $141,000 will pay less. If the final outcome is a net tax cut for individuals, the break-even point will be higher. Fewer than 2 percent of taxpayers earn more than $141,000 annually.

Exhibit 2

Potential Effect of Replacement Revenue on High-Income Homeowners

	Home Value					
	$100,000		$200,000		$300,000	
Income Level	Current School Prop. Tax (40 mills)	Replacement Taxes (17 mills + 1.3% Inc. Tax)	Current School Prop. Tax (40 mills)	Replacement Taxes (17 mills + 1.3% Inc. Tax)	Current School Prop. Tax (40 mills)	Replacement Taxes (17 mills + 1.3% Inc. Tax)
$100,000	$3,000	$2,465	$4,000	$2,890	$6,000	$3,740
150,000	3,000	3,115	4,000	3,540	6,000	4,390
200,000	3,000	3,765	4,000	4,190	6,000	5,040

SOURCE: Public Sector Consultants, Inc.

As with most property tax cut plans, renters will not receive relief unless landlords reduce rents. Because of the dramatic nature of the SB 1 reduction, this actually may happen in some cases, particularly in areas where vacancy rates are high; it is more likely, however, that rents will increase more slowly than they would have normally. Lower property taxes make home ownership more attractive and could increase apartment vacancy rates, putting downward pressure on rents.

Most senior citizens will not gain much from the repeal of school taxes because they will lose one dollar of property tax credit for each one-dollar reduction in property taxes. The exceptions will be seniors currently constrained by the $1,200 limit on the credit.

Business

Business could be a big winner because it is unlikely that all of the $2.6 billion in repealed business property taxes will be fully replaced. However, if one assumes a 18.5-mill statewide property tax (for full replacement of lost revenue), the single business tax (SBT) will have to be increased from 2.35 percent to 3.95 percent to replace all of business's property tax savings. This will result in major shifts in the tax burden, with property-rich firms (such as manufacturers and real estate companies) winning and property-poor businesses (such as those in the services sector) losing.

One consequence of the repeal of school property taxes could be the elimination of industrial property tax abatements; they will not be as necessary with a lower property tax burden. We believe the legislature should eliminate local tax abatements and give only the state the authority to grant abatements. This will reduce the current destructive local competition and better serve the interests of the entire state. (Such a move could be combined with an enterprise zone program to help depressed areas.)

Property Values

A reduction in property taxes will result in higher property values. Lower property taxes reduce the carrying costs for homes and allow homeowners to finance larger mortgages. For example, a reduction of $1,200 annually in property taxes would allow a homeowner to increase his/her mortgage by $14,000 (assuming 7.5 percent interest for 30 years) and still have the same total monthly payment. This will increase demand for homes and drive up property values.

Property taxes are reflected, or capitalized, in the value of property. Full capitalization rarely occurs, however. Studies show that the degree of capitalization tends to fall as the process of evaluating the housing market becomes more complex. Characteristics contributing to market complexity include an area's mix of (1) older and newer homes, (2) housing styles and sizes, and (3) residential and commercial property. The more homogeneous an area's mix, the higher the degree of capitalization. For example, an area of similarly sized older homes, with little commercial property, may see 60 percent capitalization. In contrast, an expanding suburban area, where large, new homes are being built among small, old homes, may only see 25 percent capitalization. Applying these rates to the fully capitalized $14,000 figure cited above produces home value increases of $8,400 and $3,500 for the respective areas.

We also can calculate the statewide effects of capitalization for the legislated millage reduction. In 1994 the average owner-occupied home will be *assessed* at approximately $50,600. A 20-mill net reduction (assume 17 mills of the currently legislated 37-mill reduction are replaced) will translate into a $1,010 annual tax cut. At a 50 percent capitalization rate and a 7.5 percent mortgage rate, this cut will produce an increased value of $6,750 per home. In total, capitalization produces $7.4 billion in additional assessed value. If the legislature reinstitutes 17 mills of the current tax cut, this additional assessed value will generate $126 million in new property tax revenue, an amount equal to 0.7 mills.

The analysis that follows does not account for an increase in property values resulting from lower property taxes. To the extent this occurs, the tax rates described in the revenue options section below could be reduced slightly.

State and Local Budgets

The most probable outcome of SB 1 is that not all of the revenue lost by schools will be replaced, and a portion of the loss will be absorbed by reductions in the state budget. The losers in this case are likely to be higher education, social services, and state employees in general. Excluding school aid, higher education

and social services account for about 50 percent of general fund–general purpose expenditures. If mental health, corrections, and state police are added, the share increases to 85 percent. In view of the sharp cuts made in recent years and an estimated $500 million structural (permanent) deficit in the FY 1993–94 budget, it is unlikely that significant cuts can be made without inflicting considerable pain. The governor is pushing privatization, but aside from a one-time windfall from the sale of the Accident Fund, any substantial savings are several years away. Groups that depend on the state budget, including local governments, are in for very tough times in the foreseeable future. Local governments could be particularly vulnerable, because increased state support of schools will count as state payments under Article IX, Section 30, of the state constitution (which requires that 41.6 percent of the state budget consist of funds paid to local governments), and this will allow the state to reduce payments—which include community college funding—to local governments.

Another outcome of replacing local property taxes with state taxes is that the state will be constrained in raising state taxes for other purposes without voter approval.

COMPARISONS WITH OTHER STATES

Michigan's high property taxes relative to other states is one of the factors behind the repeal of school property taxes. As shown in Exhibit 3, in 1990–91 Michigan collected 42.4 percent of state and local taxes from the property tax, ranking the state 6th highest in the nation. Michigan's rank is certain to be lower under the new system. If only one-half the repealed property taxes are replaced with new property taxes, about 27 percent of Michigan's state and local revenue will come from property taxes, and the state will rank about 34th among the states. As also shown in the exhibit, Michigan ranks very low (44th) in sales tax collections and about average (29th) in income tax collections.

A major reason why Michigan property taxes have been high is that state government has provided a low level of support to K–12 education. As shown in Exhibit 4, state government in Michigan provides only 35.5 percent of the revenue for K–12 education; only eight other state governments provide less. Under the new system it is likely that the state will provide a larger share of the funding than any state except Hawaii, which has a statewide school system.

REVENUE OPTIONS

Because of the amount of revenue that must be replaced, options are limited. The following are the only sources of revenue sufficiently large to be useful in replacing the lost revenue (only a relatively small amount of revenue, perhaps to fill in gaps, can be generated by cigarette, liquor, and beer and wine taxes):

- State income tax
- State sales tax (increase in rate and/or base)
- Single business tax
- Statewide property tax
- Local property, income, or sales tax

There are several constraints—constitutional, political, and practical—that must be factored into the revenue replacement equation. First, Article IX, Section 26, of the Michigan Constitution limits state revenue to 9.49 percent of Michigan personal income. Our estimate is that state revenue will be about $3.8 billion below the limit in FY 1994–95. This means that only a little more than half the amount needed to fully replace school property taxes can be raised by state taxes. The constitution does allow the governor and the legislature (with a two-thirds vote) to declare an emergency and exceed the limit, but only for one year. To replace school property taxes permanently with state taxes would require such an emergency vote each year, which clearly would violate the provision's intent.

Exhibit 3

Property Taxes as a Percentage of State and Local Taxes

Rank	State	Property Tax (%)	Rank	State	Sales/ Gross Receipts Tax (%)	Rank	State	Individual Income Tax (%)
1	New Hampshire	70.0	1	Nevada	63.2	1	Maryland	39.0
2	New Jersey	45.2	2	Washington	62.1	2	Massachusetts	36.1
3	Vermont	43.6	3	Tennessee	60.2	3	Delaware	34.3
4	Oregon	43.5	4	New Mexico	55.8	4	Oregon	33.7
5	Connecticut	42.7	5	Louisiana	51.5	5	Kentucky	31.9
6	**Michigan**	**42.4**	6	Hawaii	51.4	6	North Carolina	31.4
7	Rhode Island	41.3	7	Florida	51.0	7	Ohio	30.2
8	Wyoming	40.5	8	Texas	50.1	8	New York	28.8
9	Maine	39.2	9	Alabama	49.6	9	Minnesota	28.6
10	South Dakota	38.9	10	Mississippi	48.2	10	Wisconsin	27.2
11	Texas	38.7	11	South Dakota	46.9	11	Hawaii	26.8
12	Nebraska	38.1	12	Arkansas	46.7	12	Idaho	26.8
13	Florida	37.5	13	Oklahoma	43.1	13	Virginia	26.3
14	Illinois	36.8	14	West Virginia	42.9	14	Indiana	25.6
15	Kansas	35.8	15	Arizona	42.8	15	Utah	25.2
16	Wisconsin	35.8	16	Missouri	42.4	16	Arkansas	25.1
17	Montana	35.7	17	Utah	40.7	17	South Carolina	25.0
18	Iowa	35.2	18	North Dakota	40.0	18	Missouri	24.9
19	Colorado	35.2	19	Georgia	40.0	19	Georgia	24.8
20	Massachusetts	33.6	20	Connecticut	38.8	20	Iowa	24.7
21	Arizona	33.0	21	South Carolina	38.3	21	California	24.3
22	New York	33.0	22	Illinois	35.8	22	Montana	23.9
23	Indiana	32.8	23	Idaho	35.7	23	Pennsylvania	23.2
24	Virginia	32.6	24	Colorado	35.5	24	Maine	23.1
25	Minnesota	30.6	25	North Carolina	35.2	25	Oklahoma	23.0
26	Pennsylvania	29.8	26	Indiana	35.0	26	Colorado	22.2
27	Ohio	29.2	27	Kentucky	35.0	27	Alabama	22.0
28	North Dakota	29.1	28	California	34.8	28	Vermont	21.4
29	Georgia	28.2	29	Nebraska	34.7	**29**	**Michigan**	**21.2**
30	California	28.0	30	Kansas	34.1	30	Rhode Island	20.1
31	Washington	28.0	31	Ohio	31.8	31	West Virginia	19.6
32	Alaska	27.5	32	Rhode Island	31.6	32	Nebraska	19.4
33	South Carolina	27.1	33	Virginia	30.5	33	Illinois	18.4
34	Maryland	27.0	34	Minnesota	30.0	34	Kansas	18.3
35	Idaho	26.6	35	Maine	29.7	35	Arizona	16.6
36	Mississippi	26.4	36	New Jersey	29.6	36	New Jersey	15.7
37	Utah	26.0	37	Pennsylvania	29.3	37	Mississippi	14.2
38	Missouri	23.6	38	Iowa	28.6	38	New Mexico	13.9
39	Nevada	23.5	39	Wisconsin	28.4	39	Louisiana	11.4
40	Tennessee	23.3	40	New York	26.9	40	North Dakota	10.4
41	North Carolina	22.9	41	Wyoming	26.8	41	Connecticut	5.4
42	Arkansas	18.1	42	Vermont	26.1	42	New Hampshire	1.7
43	West Virginia	16.7	43	Maryland	25.4	43	Tennessee	1.4
44	Louisiana	16.7	**44**	**Michigan**	**23.1**	44	South Dakota	0.0
45	Kentucky	16.0	45	Massachusetts	20.2	45	Texas	0.0
46	Hawaii	15.0	46	Montana	15.5	46	Alaska	0.0
47	Oklahoma	15.0	47	New Hampshire	14.7	47	Florida	0.0
48	Delaware	15.0	48	Delaware	12.2	48	Nevada	0.0
49	New Mexico	12.9	49	Oregon	9.0	49	Washington	0.0
50	Alabama	12.5	50	Alaska	7.6	50	Wyoming	0.0
	AVERAGE	32.0		AVERAGE	35.3		AVERAGE	20.8

SOURCE: U.S. Data on Demand, Inc. and State Policy Research, Inc., *States in Profile: The State Policy Reference Book*, 1993.

Exhibit 4

Estimated Percentage of Revenue from Government Sources for Public Elementary and Secondary Schools, 1991–92

Rank	State	Local Government (%)	Rank	State	State Government (%)	Rank	State	Federal Government (%)
1	New Hampshire	89.9	1	Hawaii	92.4	1	Mississippi	16.9
2	Oregon	63.2	2	New Mexico	75.9	2	Alabama	13.6
3	South Dakota	62.4	3	Washington	74.0	3	Alaska	12.6
4	Massachusetts	62.1	4	Kentucky	69.4	4	South Dakota	11.6
5	Virginia	61.9	5	Delaware	67.6	5	New Mexico	11.2
6	Vermont	61.6	6	West Virginia	67.0	6	Tennessee	10.5
7	**Michigan**	**59.9**	7	California	66.3	7	Arizona	9.8
8	Nebraska	59.2	8	Alabama	65.1	8	Louisiana	9.8
9	Nevada	58.8	9	North Carolina	65.1	9	Kentucky	9.4
10	Illinois	57.1	10	Alaska	63.6	10	North Dakota	9.3
11	Missouri	56.6	11	Oklahoma	63.5	11	Arkansas	8.8
12	Maryland	56.3	12	Arkansas	62.8	12	South Carolina	8.7
13	Colorado	56.0	13	Idaho	62.0	13	Montana	8.5
14	Rhode Island	56.0	14	Utah	57.1	14	Delaware	8.4
15	New York	55.9	15	Montana	56.3	15	West Virginia	8.0
16	Connecticut	55.7	16	Louisiana	55.0	16	California	7.9
17	New Jersey	55.3	17	Indiana	53.3	17	Texas	7.9
18	Wisconsin	54.5	18	Georgia	52.9	18	Hawaii	7.5
19	Kansas	53.6	19	Mississippi	52.5	19	Illinois	7.5
20	Ohio	51.6	20	Wyoming	52.5	20	Idaho	7.4
21	Arizona	48.6	21	Minnesota	51.6	21	Oklahoma	7.4
22	Pennsylvania	48.4	22	Iowa	51.5	22	Florida	6.7
23	Texas	48.0	23	Maine	48.3	23	North Carolina	6.6
24	Florida	46.6	24	South Carolina	48.2	24	Utah	6.4
25	North Dakota	46.6	25	Pennsylvania	46.9	25	Maine	6.3
26	Maine	45.4	26	Florida	46.6	26	Nebraska	6.2
27	Tennessee	45.1	27	Tennessee	44.4	27	Georgia	6.1
28	Minnesota	44.3	28	Texas	44.1	28	Massachusetts	5.8
29	Iowa	43.1	29	North Dakota	44.0	29	Oregon	5.8
30	South Carolina	43.1	30	Ohio	42.7	30	Wyoming	5.8
31	Indiana	41.9	31	Wisconsin	42.0	31	Ohio	5.7
32	Wyoming	41.7	32	Arizona	41.6	32	Missouri	5.5
33	Georgia	41.0	33	Kansas	41.4	33	Vermont	5.5
34	Utah	36.4	34	New Jersey	41.4	34	Washington	5.5
35	Louisiana	35.3	35	Connecticut	40.4	35	Iowa	5.4
36	Montana	35.2	36	Rhode Island	40.0	36	Maryland	5.2
37	Idaho	30.6	37	Colorado	39.5	37	New York	5.1
38	Mississippi	30.6	38	New York	39.0	38	Kansas	5.0
39	Oklahoma	29.1	39	Maryland	38.5	39	Indiana	4.9
40	Arkansas	28.4	40	Missouri	37.9	40	Virginia	4.9
41	North Carolina	28.3	41	Nevada	37.1	41	Pennsylvania	4.7
42	California	25.8	**42**	**Michigan**	**35.5**	42	Colorado	4.6
43	West Virginia	25.0	43	Illinois	35.4	**43**	**Michigan**	**4.6**
44	Delaware	24.0	44	Nebraska	34.6	44	Minnesota	4.2
45	Alaska	23.8	45	Virginia	33.2	45	Nevada	4.1
46	Alabama	21.4	46	Vermont	32.9	46	Rhode Island	4.0
47	Kentucky	21.3	47	Massachusetts	32.2	47	Connecticut	3.9
48	Washington	20.5	48	Oregon	30.9	48	Wisconsin	3.5
49	New Mexico	12.9	49	South Dakota	26.0	49	New Jersey	3.3
50	Hawaii	0.1	50	New Hampshire	7.6	50	New Hampshire	2.5
	AVERAGE	45.7		AVERAGE	47.9		AVERAGE	6.4

SOURCE: U.S. Data on Demand, Inc. and State Policy Research, Inc., *States in Profile: The State Policy Reference Book*, 1993.

After adjusting for an estimated $800 million reduction in state property tax credits and the reduction in state property taxes, the maximum revenue that can be raised by state taxes without voter approval is about $3.2 billion. This means that at least a 18.5-mill property tax must be levied locally or statewide (and collected and distributed regionally to avoid the constraint imposed by the state tax limit). It must be noted that instituting a 18.5-mill state or local property tax will reduce the estimated $800 million property tax credit savings by about $400 million. This will increase the amount that can be raised under the state tax limit to about $3.6 million, but it also will increase the total replacement revenue required. One option to reduce the amount of replacement revenue required would be to repeal the homestead tax credit.

Second, the rate increases needed to replace the lost revenue are so large that there would be massive shifts in tax burdens, and politicians likely will not vote for such large increases. For example, to fully replace the taxes on business would require an increase in the single business tax rate to nearly 4 percent (the current rate is 2.35 percent). Third, to increase the sales tax rate (4 percent) requires a vote of the people. To fully replace school revenue through the sales tax would require the rate to be raised to 10.5 percent. The voters would not approve such a rate, and they should not because it would create a serious competitive problem for Michigan retailers, particularly those near state borders. However, voters might be willing to approve a 1 or 2 cent increase to supplement other replacement sources. Applying the current sales tax rate to services currently exempt could raise about $1.4 billion (the constitution specifically exempts only food and prescription drugs—not services—from the sales tax).

These constraints suggest that the only practical approach is to blend state and local taxes in a way that will comply with the state tax limit, keep rate increases relatively moderate, minimize competitiveness problems with businesses in other states, and possibly give local governments some capability to raise the replacement revenue they need.

The first decision that must be made in designing a revenue replacement package is to determine how much revenue is to be replaced. This depends in large part on the type of school system agreed upon. The second is how the burden shall be distributed between individuals and business. The third is whether to allow local governments the option of levying various taxes. The fourth decision is whether to retain the state homestead credit program. Described below and presented in Exhibit 5 are several options.

Option one assumes full replacement by the state of the lost revenue, continued operation of the homestead tax credit, and no local taxing option. The package would consist of a 21-mill statewide school property tax, an increase in the SBT rate from 2.35 to 3.35 percent, and an increase in the personal income

Exhibit 5

Six Revenue Options to Replace School Property Taxes

	Option					
Revenue Source	**1**	**2**	**3**	**4**	**5**	**6**
Income tax increase	1.4%	1.4%	1.1%		1.4%	
SBT increase	1.0%	1.0%	1.5%	1.0%	1.0%	1.0%
State property tax	21.0 mills	15.5 mills	16.0 mills	11.0 mills	17.0 mills	21.0 mills
Local property (or income) tax			5.0 mills	5.0 mills		
Sales and use taxes increase						2.0
Sin taxes (millions)				$400		
Sales tax on services (millions)				$1,400		
TOTAL REVENUE (millions)	$6,458	$5,479	$6,518	$5,548	$5,746	$6,588

SOURCE: Public Sector Consultants, Inc.

tax rate from 4.6 to 6 percent (the increase in the income tax rate could be reduced to 5.7 percent if the homestead credit were repealed). As mentioned, the statewide property tax may have to be collected and distributed regionally; however, if so, it then could be considered a "local" tax and subject to the provisions of the Headlee amendment requiring voter approval of increases.

Option two assumes a net $1 billion tax cut from the full replacement level and would require roughly a 6 percent total reduction in the state and school budgets. This package would include a 15.5-mill state property tax, a 6 percent personal income tax rate, and a 3.35 percent SBT. A variation is to allow voters to choose an increase in the sales tax in exchange for increases in the current income and single business taxes—a sales tax increase to about 6.8 percent would be required.

Options three through six are variations of the first two. *Option three* would provide full reimbursement and a 5-mill local tax (high-spending districts could be given the option of levying more mills or a local income tax). It assumes complete replacement of all business taxes, requiring a 1.5 percent increase in the SBT rate and an income tax rate of 5.7 percent. *Option four* would provide a $1 billion tax cut and replace the income tax increase with "sin" (tobacco and alcohol) taxes and a sales tax on services. *Option five* would replace 90 percent of the lost revenue, requiring a 17-mill state property tax in addition to income and single business tax increases. This package would require budget reductions (or increased efficiencies) of about 3.5 percent, or about $250 million from the state budget and $350 million from school budgets. *Option six* would allow voters to opt for a 2 percent increase in the sales tax in place of the income tax hike.

Each option could be adjusted in a number of ways by raising or lowering the various rates. For example, the income and SBT rates could be increased to reduce statewide property taxes (but the total yield of the income tax and SBT cannot exceed about $3.2 billion).

An alternative to the SBT is a statewide property tax on industrial and commercial property; however, this would require an additional 15 mills on such property, and this seems unreasonable because business then would pay property taxes as high or higher than at present. Because of the constraints mentioned above, the final package is likely to include a mix of state and local property taxes as well as income and single business tax rate increases—unless the voters opt to raise the state tax limit or increase the sales tax rate.

A completely different approach would be to allow all districts to charge tuition and provide families with school children with tax credits based on income level. This would be particularly appropriate if a schools-of-choice plan is adopted.

The ultimate option would be to say "oops!" and return to the local property tax, but this is highly unlikely.

OPTIONS FOR DISTRIBUTING FUNDING AND REFORMING EDUCATION

We believe there is consensus in the legislature for distributing funds to schools through the use of a foundation grant such as was part of Proposal A. If all categoricals appropriated to schools were eliminated except for special education and funds to intermediate school districts, and state contributions to the teacher retirement system were stopped, the money saved, in combination with the full property tax replacement amount, would support a per pupil grant of about $5,600. If the legislature would adjust this grant for regional cost differences (and we believe this would be the proper course), most school districts would benefit from a considerable increase in funding. As under Proposal A the annual increase could be limited to 10 percent and the foundation grant tied to the increase in the revenue earmarked for schools. Districts currently spending more than $5,600 could be permitted to ask voters to approve a small property tax, for example, up to 5 mills. This still would leave such districts as Birmingham about $2,000 per pupil short of their current level of expenditures (or less if regional cost differences are reflected in the grant). Although this puts such districts in a difficult position, allowing some districts to continue to spend at a level well above others is not consistent with the goal of reducing disparities among districts.

Although the most important decisions that must be made by the governor and the legislature involve funding and distribution, this is the perfect opportunity to consider other important reforms. In a 1989 paper entitled, "The State of Education in Michigan," we recommended a number of reforms in school organization, curriculum, testing, and teacher training and compensation. The following are the most critical of these proposals:

- Reduce the number of school districts from 559 to 107 (one district in each county except for the eight most populous counties, each of which would have four districts); abolish all non-K–12 districts; and reduce the number of intermediate districts from 57 to 20
- Institute a longer school year; reduce K–3 class sizes and increase class sizes in higher grades; and place more emphasis on math, science, computer training, and foreign languages
- Centrally hire all teachers and impose a statewide pay scale, adjusted for cost of living differences; offer teachers an early retirement program and permit transfers between districts; institute a merit pay system for teachers and create a category of master teachers who would teach classes on statewide television and at central locations around the state
- Inaugurate annual statewide testing in various subjects and award scholarships to special summer programs to students who achieve the highest scores; require seniors to pass a special examination as a condition of graduation and award college scholarships to those with the highest scores
- Evaluate each school building annually, using selected criteria; rank and compare buildings statewide; and publish the results

CONCLUSION

The governor and the legislature have been presented with an historic opportunity to improve Michigan's education system, tax structure, and economy. The task is arduous, and the best thinking of all interested parties will be needed. We hope that all aspects of our system of K–12 education will be examined, but that the need for continued funding for other important areas such as higher education, mental health, social services, and infrastructure will not be ignored in a mad rush to reduce taxes. Although Michigan has had very high property taxes, our *overall* tax burden is right at the national average. We believe that both the state and local school districts can become more efficient, but we urge caution in listening to the siren song from special interests for large tax reductions.