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Michigan COMMENTARY

SCHOOL FINANCE REFORM

by Robert Kleine

The legislature is nearing agreement on school finance reform. The joint conference committee has reached an understanding on most major points and needs only to work out a few details. The full legislature likely will approve the conference committee accord in the fall.

This commentary describes the key features of the current school finance reform plan tentatively agreed on by the joint House-Senate Conference Committee. Also discussed are whether the sales tax should be used to provide property tax relief, whether the proposal offers a reasonable level of property tax relief, and whether the proposal will adequately reduce the disparity among districts in resources per pupil.

PSC concludes that, although this is a good proposal, voter approval is unlikely, and the legislature should then pursue a statutory solution.

Key Points of the Reform Plan

- The state sales tax would increase from 4 percent to 6 percent, effective May 1, 1989.

- School operating millage would be limited constitutionally to 28 mills for the first three years. After that, up to two mills could be levied for enrichment if local voters approve. (The 28 mills would not require voter approval.) A provision for additional voter-approved increases in millage for financially distressed school districts would be provided by statute.

- For the first year, school districts would be fully reimbursed by the state for reduced property taxes; thereafter, reimbursement would be based on the district's actual SEV growth, the statewide SEV growth, or the increase in school aid fund revenues, whichever is less.

- A $7,500 homestead exemption for school operating millage would be reimbursed by the state.

- All revenue from the sales tax increase would be constitutionally earmarked for the school aid fund; no agreement has been reached on how to deal with shortfalls in revenues.

- The 50-mill noncharter millage limit would be reduced on a district-by-district basis by the difference between a local school

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district's current allocated millage and 28 mills for the first three years, 30 mills thereafter.[1]

- There would be an exemption for residential utilities from sales tax and an income tax credit for low-income senior citizens and renters.

- A fund of $20 million to improve school quality would be established by statute.

Agreement has not yet been reached on a distribution formula, but it will likely be set by statute, not constitutional amendment, and it probably will be a minimum guarantee of $104 per mill up to 28 mills.

The fiscal effect of the proposal is shown in Exhibit 1.

Discussion

The major goals of school finance reform are to provide property tax relief, increase the equity of school financing, and improve the quality of education. Given the current political environment, the reform proposal is sound in its pursuit of the first two of these goals. In regard to the third, increasing the equity of school financing in turn will help increase the quality of education, a goal that also will be addressed by companion legislation. There are, however, three significant questions about the reform proposal which merit examination.

Is an increase in the sales tax the best way to provide property tax relief? As indicated in Exhibit 2, the sales tax is regressive, that is, it has a larger effect on low-income persons than on high-income persons. A 2 percent sales tax takes about 1.1 percent of income in the $5,000-$10,000 income class and only 0.6 percent of income in the $40,000-and-over bracket. The property tax is also regressive (if measured against current income), but the state property tax credit program (the "circuit breaker") makes it less regressive than the sales tax. The provision to exempt the sales tax on utilities improves the tax somewhat, as this is the most regressive portion of the sales tax. The personal income tax would be a much more equitable replacement for the sales tax, but this is not politically feasible.

Another reason for favoring the income tax over the sales tax is that the income tax (and the property tax) are an itemized deduction for federal income tax purposes, whereas the sales tax is not. The income tax approach would benefit the 35 percent of Michigan taxpayers who itemize deductions.

There are two practical reasons, however, for using the sales tax to provide property tax relief. First, the sales tax is underutilized in Michigan, and the property tax is overutilized. The sales tax is 3.09 percent of personal income in Michigan, which ranks it 45th among all the states

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[1] Cities, villages, and townships without voter approved charters are subject to a limit of 50 mills for operating purposes (debt is excluded). In most jurisdictions almost the only mills not excluded from the limit are school operating mills.

EXHIBIT 1

ESTIMATED FISCAL EFFECT OF SCHOOL FINANCE PROPOSAL
(FY 1989-90, millions of dollars)

Tax Reduction	
28-mill school operating limit	
Individual property tax relief	$405
Business property tax relief	209
Utility property tax relief (taxed at state level)	15
$7,500 SEV homestead exemption	487
"Circuit breaker" reduction[a]	(184)
Utility tax exemption for all households	240
Increase circuit breaker for seniors/renters	30
TOTAL REDUCTION	$1,202
New Revenue	
2-cent sales/use tax increase	$1,608
NET TAX INCREASE	406
Increase in general fund/general purpose spending for schools above FY 1988-89 target	110
TOTAL INCREASE FOR SCHOOLS	$516
Addenda	
Statutory tax change for individuals[b]	+$260
Statutory tax change for business	+$146
Percentage decrease in aggregate individual property taxes	15.8%
Percentage decrease in aggregate business property taxes	8.6%

SOURCE: Senate Fiscal Agency.

[a] State income tax credit for homeowners and renters with property taxes in excess of 3.5 percent of household income.

[b] Assumes the sales/use tax is split 23 percent/77 percent between business and individuals.

EXHIBIT 2

ESTIMATED EFFECT OF 2 PERCENT SALES TAX BY INCOME CLASS

	0-$5,000	$5,000-9,999	$10,000-14,999	$15,000-19,999	$20,000-29,000	$30,000-39,999	$40,000 and over
Average income before taxes	$2,344	$7,388	$12,426	$17,341	$24,676	$34,283	$61,693
Taxable consumption[a]	4,461[b]	4,169	5,990	7,408	9,745	12,147	18,751
Two percent sales tax applied to taxable consumption	89	83	120	148	195	243	375
Sales tax as percentage of income	3.8%	1.1%	1.0%	0.8%	0.8%	0.7%	0.6%
Addendum: utilities as percentage of income	48.2%	16.7%	11.3%	8.5%	6.7%	5.6%	3.8%

SOURCE: United States Department of Labor, *Consumer Expenditure Survey: Results From 1986* (Washington, D.C.: April 1988).

[a]Excludes food, shelter, utilities, and other nontaxable items.

[b]Consumption exceeds income because of unreported income and financing of consumption out of savings and debt.

(1985-86 data). The U.S. average is 4.08 percent. A 2-cent increase would put the Michigan sales tax at the national average. In Michigan, property taxes are 4.8 percent of personal income, ranking the state sixth. The U.S. average is 3.4 percent. Second, most polls show that the sales tax is the least unpopular tax, while the property tax and the federal income tax are the most unpopular.

Does the proposal provide a reasonable level of property tax relief? The answer depends on several factors: taxpayers' current millage rates, the value of their homes, and whether they receive the current state property tax credit. Taxpayers in low millage districts with homes of low value would receive less property tax relief than taxpayers in high millage districts living in homes of high value. For example, a person living in a district with a school operating millage rate of 28 mills would receive no relief from the millage rollback, but $210 from the $7,500 SEV exemption. However, if this person were eligible for the state property tax credit (and not a senior citizen), the credit would be reduced by $126. A taxpayer living in a 40-mill district with a home valued at $60,000 would receive $360 in relief from the millage rollback and $210 from the SEV exemptions. Again, if this taxpayer were eligible for the state property tax credit, there would be an offsetting reduction in the credit of $342. Therefore, net property tax relief would be $92 in the first case and $228 in the second.

The proposal would result in taxpayers with a high property tax burden relative to income receiving little more (or less in some cases) relief than taxpayers with a low property tax burden relative to income. In the case of senior citizens, relief from the millage rollback and the SEV exemption would be completely offset by the loss of state property tax credits. However, the proposal does include a low-income credit that would provide some relief to senior citizens.

Our view is that many homeowners, particularly senior citizens, will view the proposal as providing a relatively small amount of property tax relief. Renters will be particularly concerned, although the package includes an increase in their property tax credit. Two features of the proposal, however, may offset such negative reactions. The $7,500 SEV exemption will be very attractive to homeowners in low millage districts who otherwise would receive no relief, and the 28 (or 30) mill cap will be popular with most homeowners. Indeed, without these two provisions, the proposal would have virtually no chance of passage. We believe that the millage cap is not good tax policy, but it is absolutely essential to win voter approval. On the one hand, it makes little sense to prevent local voters from determining their own millage rate. On the other hand, it must be recognized that one of the taxpayer's greatest fears is being stuck with a higher sales tax while property taxes creep back up to the current level.

Would passage of this proposal adequately reduce the disparity among districts in resources per pupil? About $500 million in additional money for K-12 education would be provided, and resources in the low-spending districts would be increased, but in the high-spending districts the level would not be lowered.

As indicated in Exhibit 3, 326 districts (57.9 percent of the total) have revenue of $2,900 or less per pupil. These districts would receive additional resources and would move near the state average of $3,067 per pupil. Only 81 districts (14.4 percent of the total) have resources of $3,500 or more per pupil (these districts have 18.8 percent of all pupils). These districts will

EXHIBIT 3

SELECTED CHARACTERISTICS OF MICHIGAN SCHOOL DISTRICTS, FY 1987-88

Revenue Level	Average Revenue per Pupil	Number of Districts	Percentage of Students	Average Number of Students	Average SEV per pupil	Average Operating Millage
$ 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.

be largely unaffected, although many would lose the flexibility to raise additional resources with millage increases.

It is improbable that school district resources ever will be totally equalized, but this proposal makes a good start by helping districts whose resources are below average. Our view is that the best to be hoped is to bring the low-resource districts up to a reasonable level and slow the growth in the high-spending districts. The state reimbursement for the rolled-back mills would provide some equalization by reimbursing out-of-formula districts on the basis of district SEV growth, state SEV growth, or school aid fund growth, whichever is less. For example, if district SEV were to increase 10 percent annually, state SEV 5 percent, and school aid revenue 6 percent, reimbursement would increase only 5 percent annually. This would narrow the gap between the districts with fast growth and high spending and those with low growth and low spending. However, all school districts would receive local SEV growth on the first 28 (or 30) mills. Overall, our view is that the proposal would improve significantly the equity of school financing.

Comment

PSC believes that, given political realities, this is about the best proposal that could be placed on the ballot by the legislature. In an ideal world, we would prefer to see a statutory solution that would use the personal income tax and the single business tax as the primary revenue sources to finance reduced property taxes on individuals and businesses. We also would like to see the statewide collection of business property taxes, with the monies redistributed to reduce funding disparities. But this is far from an ideal world, and one must take what one can get. This proposal deserves voter approval, but given the strong distrust of government and the history of local control in Michigan, the outcome is likely to be little different than in the past. (See Exhibit 4). One more failure should convince the legislature that the problem must be addressed statutorally, not constitutionally. The school finance problem will not go away. Almost everyone agrees that our financing system is flawed and prevents equal access for all to a quality education. The legislature has developed a good proposal, but if it fails, a better proposal must be enacted by statute. We have delayed long enough.

Robert J. Kleine is the senior economist at Public Sector Consultants. He has extensive experience in state budget, taxation, and economic issues. As director of the Michigan Office of Revenue and Tax Analysis, he was responsible for state revenue and economic forecasting, tax analysis, and the development of state tax policy. He played a major role in developing the state's single business tax and the property tax relief program. More recently, Mr. Kleine served as senior analyst in public finance at the Advisory Commission on Intergovernmental Relations in Washington, D.C. His studies on cigarette tax evasion, value added taxation, federal tax reform, revenue and program turnbacks, and state and local tax systems received national recognition.

Mr. Kleine has a B.A. in economics and history from Western Maryland College and a M.B.A. in finance from Michigan State University.

EXHIBIT 4

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

Proposal	Date	Percentage For	Percentage Against
Limit property taxes and establish state school tax	November 1972	42.2%	57.8%
Abolish property taxes for school operations and establish voucher plan	November 1978	25.7	74.3
Reduce property taxes and allow school income tax with voter approval (Tisch)	November 1978	37.3	62.7
Reduce property tax maximums and increase state aid (Tisch)	November 1980	44.2	55.8
Reduce property tax maximums and increase state aid	November 1980	21.2	78.8
Reduce property taxes and raise sales tax	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.