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Public Sector Reports

Michigan COMMENTARY

School Finance Reform Will Affect All Local Governments

by Robert Kleine, Vice President and Senior Economist, and Janet L. Lazar, Affiliated Consultant

Public Act 145 of 1993, which eliminates school operating property taxes and freezes 1994 assessments in Michigan, sparked a school finance revolution in the state that is being observed carefully nationwide. Out of the consequent debate and controversy a second revolution is emerging, a revolution in which the traditional relationships between state government and local governments are necessarily being challenged and redefined in response to the changes wrought by school finance reform. Just as residents are watching developments in school finance reform to see how it will affect their children and the quality of their education, residents must track how the reform affects changes in local funding. Residents need to understand how their local fire departments, libraries, and other important services are affected by the shifts in funding at the local level, shifts necessitated by the state reforms.

THE NEED FOR CHANGE

Local governments—cities, villages, townships, and counties—are the primary agents for providing Michigan residents with the most visible and most closely watched of public services. These local units, however, also must provide many functions mandated by the State of Michigan and the federal government, functions that often are of little personal interest to most local residents. Consequently, local officials sometimes find it difficult to fulfill such mandates and still provide the services that residents want.

Several recent developments are likely to further complicate the role of local officials: P.A. 145 and the governor's proposed elimination of revenue sharing payments that currently are allocated according to statute. As a result of these measures, local officials now face the dilemma of how to replace immediately the resources needed to fund existing debt commitments while still providing quality local services and meeting their mandated responsibilities.

This dilemma grows out of concern at the state level about how best to allocate state dollars. Underpinning the governor's proposal is concern about local units' absence of accountability measures that spell out the sources of local government funds and how the funds are spent. Most residents are unaware of how much money local units receive from the state, how much local units generate themselves, and where the dollars go. The governor hopes that if all revenues are raised locally, taxpayers will be more aware of the cost of local services and, possibly, scrutinize tax and expenditure increases more closely. In addition, the governor moved to remove incentives to raise local property taxes (e.g., revenue sharing, the state homestead tax credit, and the city income tax) and provide as much net tax relief to homeowners as possible.

WHAT THE GOVERNOR PROPOSES

Currently, local government units receive up to 30 percent of their revenues through state shared revenue distributions—that is, the state distributes to local governments some of the tax revenue it collects. A per capita portion of those distributions comes from sales tax revenues and is constitutionally designated—this amount cannot be changed without constitutional amendment. Changes can be made more easily, however, to what is not constitutionally designated, and the governor's school financing package will eliminate this remaining portion and shift the burden to local property taxes. This change will comply with constitutional limitations, which decree that at least 41.6 percent of state shared revenues must go to local governments including schools. The governor's proposed measures are outlined below.

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Revenue Sharing

Revenue sharing allocated by statute will change significantly. Specifically, the governor's proposal includes elimination or reduction of revenue sharing to local units from the following sources:

- Income, single business tax, and intangibles tax collections
- Payments in lieu of taxes for fire protection of state property
- Payments for tax-exempt senior citizen and handicapper housing
- Payments to previously in-formula schools for revenue losses from property tax abatements

Anticipated Local Revenue Loss (dollars in millions)

Statutory revenue sharing and other programs	$670
TIFA revenue	140
4 percent delinquent tax collection fee or contract	30
County 1 percent interest on delinquent taxes	84
Property tax administration fee	38
Enterprise zone revenue to Benton Harbor	2
Subtotal	$964
State hold harmless payment to Detroit	–190
Total local revenue (average of 4.5 mills)	$774

SOURCE: *Our Kids Deserve Better! New Schools for a New Century. Governor John Engler's Plan to Reform Michigan Schools*, October 5, 1993, p. 49.

Millage Allocations

The governor proposes authorizing local governments to levy millage to replace funds lost from revenue sharing, delinquent taxes, administration fees, and tax increment finance authorities (TIFAs). This authorization will be included in a constitutional amendment. The proposed allocations are as follows:

- Two mills for counties and villages
- Three mills for townships
- Six mills for cities

EFFECTS OF THE GOVERNOR'S PROPOSAL

The governor's proposal represents a fundamental shift away from broad-based revenues for locally delivered services, putting more pressure on local funds. The revenues that local governments will lose due to P.A. 145 and the governor's proposal are detailed in the exhibit. In addition, local governments will lose about $150 million due to the 1994 assessment freeze included in P.A. 145. While the allocated millage that the governor's proposal offers will offset some of the proposed loss of state shared revenues and other losses in property tax revenues, in actuality local governments face significant obstacles and potentially serious reductions.

The millage allocations will not require a vote of the people but will likely cause complaints to local officials. Worse, the property tax base does not correlate well with who will actually lose revenue. That is, the property tax base (i.e., assessment values) of low-income areas is generally lower than that of higher income areas, which means that higher millage levels will be needed in the poor areas. In many local units the full allocated millage will not replace all the lost revenue from the state and the property tax. There will be winners and losers at the local level, with affluent areas likely to fare better than poorer areas. The governor has proposed that the City of Detroit—the state's largest city, whose tax base has declined in recent years—receive a $190 million grant to replace revenue-sharing payments not covered by a local millage increase. Other areas will not be so fortunate.

After all of the arguments against property taxes as an equitable source of school financing and a much-touted 65 percent reduction in property taxes, local units will have to increase millage rates, and the distribution of resources among local governments will become more inequitable. Furthermore, many local officials may face residents' anger because some voters may feel deceived, seeing such measures as the added millages as partially nullifying the promised tax cut by changing the name of their tax, not the amount. While the governor argues persuasively that such a shift is logical, local officials will face residents' discontent.

Not only could on-going local services be in serious jeopardy, but also the credibility in financial markets of local governments and the state is of critical concern. Impairment of debt (i.e., suspicion in the financial markets that local units will be unable to repay debt due to state actions) could cripple Michigan and its local governments' ability to sell their bonds for many years to come. *Moody's* and *Standard & Poors*—the two major U.S. bond-rating companies—have already expressed concern about Michigan's situation and are watching it closely. Potential future revenue sources are *not* pledged revenues—the possible new millage revenues for TIFA obligations, special assessments, or other fees are yet to be levied. It remains to be seen if financial markets will consider the possible new sources the governor has outlined as adequate security for existing debt. In the 1980s the effects of reduced credit ratings cost taxpayers of the State of Michigan and its local units untold millions of dollars. All levels of government must ensure that state or local action or inaction do not trigger a repeat of such effects.

Even without the elimination of revenue sharing, local units face substantial revenue reductions from the loss of traditional property-tax–related revenue sources, such as collection fees and tax delinquency charges, cuts in revenue sharing in the last three state budgets, and the freeze in 1994 assessments. Shifting revenues from local jurisdictions to the schools makes it easier for the state and the schools to reach accord on undoubtedly essential school finance reform and gives the governor an overall tax cut to present to the voters. Nevertheless, while the need for school finance reform is indisputable and the call for property tax reductions resounds, it is neither prudent nor reasonable to assume that property tax inequities and other burdens can be shifted to local jurisdictions without significant jeopardy to local services, particularly in already less affluent jurisdictions.

Local residents vote for local officials they believe will deliver the services the residents want their communities to have. Such services most often are the discretionary activities that residents can see and measure, such as recreation programs, libraries, additional community police, county road patrols, or improved service levels (e.g., snow removal, street repair, or advanced medical response). If local officials cannot continue such services without resorting to substantially higher local property taxes, voters will certainly demand to know why, and the tie between higher local taxes and school finance reform may well be lost on them. Consequently, voters may direct their frustration and anger at local officials who simply are dealing with fallout from school finance reform.

The governor has proposed sweeping, well-thought-out change, not only in school financing but in the relationship of state and local government to each other and to their mutual taxpayers. Both opportunities and risks abound. In the end, however, local officials—closest and most directly accessible to the taxpayers—will bear the brunt of explaining and implementing these changes. If local officials cannot accomplish both, local services will erode rapidly, and one problem will have been solved by creating others.

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