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The Governor's School Finance Reform Plan: An Analysis

by Robert Kleine, Vice President and Senior Economist

SURPRISING DEVELOPMENTS

On October 5 Governor Engler announced his long-anticipated plan to reform Michigan school financing and replace the revenue lost from the elimination of school property taxes as the result of Public Act (P.A.) 145 of 1993. The governor's plan has many components, some of which are not directly related to K–12 education, and the governor's proposal includes several surprises.

First, the centerpiece of the plan is a proposed February 8 vote on a constitutional amendment that includes ten provisions and amends a number of sections of the state constitution. A proposal for a constitutional amendment was not unexpected, but it is surprising that the governor would propose to submit such a complex amendment to the voters, given the electorate's aversion to approving tax amendments.

Second, we are surprised that the plan replaces most of the revenue eliminated by P.A. 145. There appeared to be considerable support for forcing schools and state government to be more efficient, and we had anticipated that this efficiency would be expected to cover close to 10 percent of the lost revenue so that only about 90 percent of the revenue would be replaced.

Third, the revenue lost from the school property taxes paid by business were largely replaced, essentially nullifying business's tax cut from P.A. 145. We expected that business would receive a significant tax cut because the governor and his fiscal advisors do not believe that maintaining the same share of taxes that business paid before P.A. 145 is a relevant economic consideration. Maintaining the business share of taxes, however, is politically important, and it allows a larger net tax cut for homeowners.

Fourth, prior to the governor's announcement of his plan, the elimination of revenue sharing payments allocated by statute had been rumored. Revenue sharing, however, is a well-established, popular program, and we are surprised to see it eliminated. After the plan was released, however, the governor indicated his willingness to restore revenue sharing for cities.

Fifth, the proposal to abolish the State Tax Commission and transfer all assessment functions to the counties was unexpected. It seemed more likely that the governor would recommend that the state assume responsibility for assessing large commercial and industrial properties.

Many provisions in the governor's plan certainly will meet with considerable opposition. We do not like several of the provisions, but they are consistent with the governor's philosophy. The following five basic principles seem to have shaped the proposal:

- One, restore as little of the local property tax on homeowners as possible.
- Two, provide as much net tax relief to homeowners as possible.
- Three, avoid raising the personal income tax at all cost.
- Four, remove incentives for local governments to raise property taxes, such as revenue sharing and the state homestead tax credit.
- Five, inject as much competition and accountability into the public education system as possible.

These beliefs are held firmly by the governor and shaped his proposal. Although we criticize some aspects of the governor's proposal in this analysis, the governor has presented a comprehensive plan that is consistent with his philosophy. He has proffered a good starting point, and it is now up to the legislature to make changes as it sees fit.

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KEY FISCAL PROVISIONS

The governor's plan includes the following numerous provisions, some of which require only statutory approval and others that involve constitutional changes.

Constitutional Changes

- Eliminate local operating taxes for 523 school districts and cap millage rates for other districts to the fiscal year (FY) 1994–95 level.
- Raise the sales and use taxes by two cents, to take effect March 25.
- Require that voters be offered the chance to change or rescind the sales tax increase by submitting it to the voters again in November 2000.
- Earmark for the school aid fund all new and existing revenue (i.e., currently statutorily allocated), including the estimated $850 million automatic reduction in state property tax credits that will result because of the P.A. 145 reduction in school property taxes.
- Limit statewide property tax on nonhomeowner property to 16 mills.
- Reduce current 15- and 18-mill constitutional limitations to reflect the P.A. 145 elimination of school allocated mills.
- Authorize local governments to levy millage to replace funds that would be lost as a result of the proposed elimination of revenue sharing and the P.A. 145 effects—reduced delinquent taxes, administration fees, and tax increment finance authority (TIFAs). Cities will be allowed six mills, townships three mills, and counties and villages, two mills each.
- Reduce the 50-mill limit to reflect elimination of school operating taxes.
- Abolish the State Tax Commission and transfer authority for equalization to the counties.
- Change the State Board of Education to a 12-member body (nine elected regionally and three appointed by the governor). The state superintendent also would be appointed by the governor.

Statutory Changes

- Impose a 4 percent tax on real estate transfers and give homeowners the option of choosing whether they will pay the 4 percent tax or a 16-mill statewide property tax.
- Increase the tax on cigarettes by 50 cents per pack and extend the tax on an ad valorem basis to other tobacco products.
- Increase the single business tax (SBT) rate from 2.35 percent to 2.85 percent.
- Repeal the state homestead tax credit program. Tax credits for agricultural property (P.A. 116 of 1974) would be retained.
- Repeal city income tax credits.
- Provide a $450 refundable tax credit for senior citizens whose income does not exceed 150 percent of the poverty level.
- Extend income tax to public employee pensions for people who retire after October 4, 1994, and increase the pension exemption under state income tax from $10,000 to $15,000 for a joint filer.
- Establish a foundation grant of $4,500 to $6,500 per pupil (K–12). Districts now receiving between $4,500 and $5,500 would be guaranteed a 2 percent increase in FY 1994–95 and districts now receiving between $5,500 and $6,500 would be guaranteed a one percent increase. The grant would be indexed to growth in state school aid revenues. A portion of the state income tax would be earmarked to replace the current grant from the general fund.
- Provide a $190 million grant to the City of Detroit to replace revenue-sharing payments not covered by local millage increase.

KEY EDUCATION REFORM PROVISIONS

The governor's plan is not limited to the fiscal side of school reform. He also recommended a number of other measures designed to encourage competition, accountability, and increased efficiency in school operations. The centerpiece of the governor's proposal is a schools of choice plan in which a per-pupil grant will follow the student to the school the student attends.

Students will be able to attend schools in districts other than the one in which they live; however, districts are not required to accept students from other districts. School boards will have to establish policies that either stipulate that no out-district students will be accepted or that only a certain number of students will be accepted.

If applications exceed the stipulated number that can be accepted, a lottery will determine which students will be accepted. If a student attends a school in a district that has lower per-pupil spending than the student's home district, the difference will be deposited to a student education bank account, which the student can use for additional public education (i.e., summer school or tutoring). In addition, if a student completes high school by the end of the eleventh grade, the funds allotted for the senior year can be used for college or technical training.

Schools of choice are a controversial new approach to education reform that is being debated in many states. The jury is still out on the success of existing schools of choice. The success of the nation's oldest and best-known choice program, District Four in New York City, is still being debated.

Proponents of choice assert that competition among schools could improve education by promoting quality and accountability. The threat of losing students—and therefore funding—would force schools to regard parents and students as consumers of education and be more responsive to their needs. Some also argue that it will lead to more educational equity, because, for example, inner-city students would be allowed to attend schools in areas rich in resources. Other arguments for schools of choice are that students will be able to choose the school best suited to their particular needs and that choice will promote much needed parental involvement in education.

Opponents of schools of choice say that competition will force schools to divert time and resources away from students' needs toward producing measurable results that can be used to attract students. Critics also say that transportation costs will rise, since students will be allowed to choose their schools without regard to district lines. These critics contend that Michigan's education system already works well and that our education problems could be addressed by working within the present system.

The governor also is proposing new legislation to establish charter schools, schools that are created by businesses, groups of parents or teachers, or public entities. The idea behind charter schools is that they can meet the different needs of students by specializing in some subject matter (e.g., mathematics or the arts) or a particular group of students (e.g., those on probation). Charter schools in Michigan would be required to apply to the state for a *charter* or *authorization to operate* a school and would be subject to state regulation. Under Governor Engler's proposal, however, charter schools would be exempt from some of the regulations placed on traditional schools, such as teacher certification requirements. As with conventional schools, charter schools would be funded with a per-pupil grant from the state.

Charter schools, a recent addition to education reform movements across the country, were initiated in seven U.S. states last year. Because charter schools in these states are still in their infancy, it is too soon to assess their ability to improve education and contain costs. Michigan already has one charter school, the Wayne State University Public School, just opened this Fall. Governor Engler supports charter schools because they provide more education choices for parents and students, promote innovation in education, and increase the possibilities for tailoring education to an individual student's needs. Charter schools also would provide competition for conventional schools, providing incentives to increase quality.

Opponents claim that the governor's charter school plan is simply an indirect way to fund private schools with public money. Religious schools, however, could not become charter schools. Opponents also say that establishing charter schools will not help the majority of existing schools and would only help a minority of students. Furthermore, say opponents, this is an attempt at union busting, since collective bargaining would not have to include teachers. In addition, there are no guarantees that charter schools will differ meaningfully from traditional schools—familiar problems may follow students to these schools.

The governor also proposed two reforms that we have long supported. First is the establishment of the Governor's Education Report Card for every school building, beginning in the Fall of this year. The report card is a document that uses data on the schools to describe the performance of various aspects of a school system. This document will give students, parents, and others reliable information with which to evaluate a school's performance (e.g., test scores, dropout rates, and average class size).

Second is the establishment of a boundary commission that would make recommendations for school consolidations as well as changes in the boundaries of other government jurisdictions. The commission would work in a manner similar to the federal military base-closing commission, with recommendations presented to the legislature for a yea or nay vote (i.e., no amendments allowed). *In the past we have recommended that the number of school districts be reduced from 559 to 108 and that the number of intermediate school districts (ISDs) be reduced from 57 to 20, and we continue to urge movement toward consolidation where it is practical.*

Some changes to collective bargaining also are proposed. Particularly controversial is a provision that would allow teachers the option of not belonging to a bargaining unit.

FISCAL EFFECTS

EXHIBIT 1: Fiscal Effects of Governor's Proposal (dollars in millions)

Estimated SEV (December 31, 1993	$178,000
School operating millage rate (1993)	33.8
Tax reduction	$6,016
ISD operating tax	$510
Specific tax (PA 198)	180
State utility property tax	100
Local governments	165
Gross property tax reduction	$6,971
State homestead tax credit	–$1,020
Net property tax reduction	$5,951
Net residential/agricultural reduction	3,329
Net business tax reduction	2,622
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)	850

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

Exhibits 1 and 2 present a breakdown of the nearly $7 billion in property taxes repealed by P.A. 145 and the replacement revenues proposed by the governor. The governor has recommended that about $6.7 billion in revenue be replaced. We estimate that a net tax cut of $270 million will result; the governor's estimate is $304 million. However, the reduction in property taxes will reduce federal tax deductions and result in higher federal income taxes.

We calculate that property taxes paid by individuals will decline by about $2.2 billion, which includes a net loss of $1 billion in state tax credits. Assuming that about 50 percent of property taxes are paid by taxpayers who itemize and that the average marginal tax rate is 26 percent, their federal income taxes would increase by an estimated $285 million, reducing the tax cut to near zero.

The estimates used in this analysis are based on the administration's revenue projections, as adjusted by PSC. Administration estimates appear reasonable, although we expect that the real estate transfer tax could generate more than their estimated $480 million, particularly in an improving housing market. The 50 cent increase in the cigarette tax also could generate more than $350 million if the federal cigarette tax is not increased by $1 per pack to finance health care reform.

One way to counteract a state revenue loss over the longer term from a drop in consumption caused by a federal tax hike or other factors is to levy an ad valorem (percent of sales price) tax on cigarettes. The rate could be set to raise the same $350 million as the 50-cent per pack tax. Since the ad valorem tax is based on retail price, its revenue would increase over time with general inflation and economic growth—assuming that cigarette manufacturers' current efforts to cut wholesale prices to offset higher taxes will not lead to lower retail prices.

At first glance the governor's plan appears to be a small tax cut, but it could easily end up being a $100 million–$200 million tax increase. For most homeowners, however, the governor's plan will mean a significant tax reduction. Those homeowners who do not move or smoke will receive a tax

EXHIBIT 2: Proposed Replacement Revenues, FY 1994–95
(dollars in millions)

Source	Amount	Individual Share	Business Share
State			
2-cent sales and use tax	$1,850	$1,350	$500
16-mill statewide property tax	1,200	265	935
4-percent real estate transfer tax	480	480	
0.5-percent increase in SBT rate	425		425
50-cent tax increase on tobacco products	350	350	
Savings on P.A. 198 (elimination of state reimbursement)	90		90
Repeal city income tax credit	33	33	
Increase exemption for pension income/tax public pensions	–23	–23	
$450 credit for low-income seniors	–120	–120	
Total state revenue	$4,285	$2,335	$1,950
Local			
ISD–special education	$383	$253	$130
Hold harmless millage (high spending districts)	190	125	65
Local millage to replace revenue sharing/TIFAs	775	511	264
Utility property tax	50		50
Total Revenue	$5,683	$3,224	$2,459
Repeal of State Homestead Credit	$1,020	$1,020	
TOTAL FUNDING	$6,703	$4,244	$2,459

SOURCES: Michigan Department of Treasury and Public Sector Consultants, Inc., October, 1993.

reduction of about $900 million (accounting for federal deductibility).

Business is estimated to receive a modest tax cut of about $165 million; the governor's estimate is $41 million. Business will lose about $160 million in federal deductions due to business's gross cut in state taxes, increasing federal business taxes about $60 million, resulting in overall modest tax reduction for business. The tax burden, however, will shift away from businesses with large property holdings. Businesses that own little property or lease will, in many cases, pay higher taxes as a result of the increase in the rate of the SBT. Businesses that lease will have to negotiate lower rents with their landlords to receive a benefit from lower property taxes.

State Tax Limit

Article IX, Section 26, of the state constitution limits the amount of revenue that the state can raise annually to the same percentage of personal income as state revenue was in FY 1978–79, 9.49 percent. To calculate the state's tax limit, take 9.49 percent of Michigan personal income for the calendar year prior to the year in which the given fiscal year begins. For example, the tax limit for FY 1994–95 will be based on 1993 personal income. The current estimate for FY 1992–93 is that state revenue will be $3.9 billion below the constitutional limit. A specific estimate has not been made for FY 1994–95, but it appears that state revenue will be more than $4 billion below the limit as state revenue is expected to increase slightly slower than personal income for the next two years.

The governor and the legislature need to raise almost $7 billion to replace fully the amount lost with the P.A. 145 elimination of school property taxes. If this is done only at the state level, however, the state limit will be exceeded by about $3 billion. One other option would have been to restore almost $3 million in local property or other taxes, which is equal to about 16 mills. Instead, the governor has chosen an option that forces him to submit part of his plan to the voters. He began by raising about $3.4 billion in state revenues, leaving a cushion under the tax limit of about $0.7 billion (see Exhibit 3). Next, he chose to exempt the revenue from the 2-cent increase in the sales tax from the state tax limit, a measure the voters will have to approve.

EXHIBIT 3: State Tax Limit (FY 1992–93 estimate, dollars in billions)

Current state revenues	$12.70
New revenues	
16-mill state property tax	1.20
Real estate transfer tax	0.50
SBT	0.42
Cigarette/tobacco tax	0.35
Elimination of homestead tax credits	1.05
Reduction in revenues	
State property taxes (utility tax/P.A. 198 of 1974)	–0.20
Senior citizen credit/other	–0.15
Total revenue	$15.87
State tax limit (9.49% of Michigan personal income for 1991)	$16.60
Amount under limit	$0.73

SOURCE: Public Sector Consultants, Inc.

The governor's proposal to eliminate revenue sharing is controversial, and he is already backing away from the proposal. Two of the advantages of eliminating revenue sharing, however, are that doing so (1) frees up almost $0.7 billion in state resources to fund the schools and (2) shifts the burden to the local property tax, thereby avoiding the restraints of the state tax limit. Normally, this would be prevented by Article IX, Section 30, of the state constitution, which requires that at least 41.6 percent of state spending be allocated to local governments. However, the large proposed increase in state payments to school districts will put the state well in excess of the required 41.6 percent and, consequently, will allow reductions in other local aid, such as revenue sharing.

COMPARISONS WITH OTHER STATES

One of the factors behind the repeal of school property taxes is that Michigan's property taxes are high relative to other states'. As shown in Exhibit 4, in FY 1990–91 Michigan collected 42.4 percent of state and local taxes from the property tax, ranking the state sixth highest in the nation. If the governor's proposal is approved, Michigan will collect about 25 percent of state and local revenue (including property transfer tax), and the state will rank about 42nd among the states. As also shown in the exhibit, Michigan ranks very low in sales tax collections (44th). If the governor's proposal is approved, Michigan will raise about 33 percent of state and local taxes from general and selective sales taxes, rising in rank to approximately 31st among the states.

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. At present, state government in Michigan provides only 35.5 percent (FY 1990–91 data) of the revenue for K–12 education; only eight other states provide less. The governor's plan would increase state support to 88 percent, ranking Michigan behind only Hawaii, which has the nation's only statewide school system.

IMPLICATIONS FOR TAXPAYERS

The proposed tax changes will have varied effects on individual taxpayers depending on their income level and whether they own a home. Exhibit 5 projects the change in total taxes paid by homeowners, renters, and seniors at the given income levels. The total change in taxes paid includes the federal deductibility of state income and property taxes. Each income level is assigned a house value or annual rent figure that was deemed representative for that level of income as well as an estimate of taxable consumption (e.g., housing, food, goods, etc.). The latter is based on the 1991 *Consumer Expenditure Survey* of the Bureau of Labor Statistics and Michigan sales tax law.

Note that the property tax relief estimates are based on the fall of the state average millage rate from its current level of 58.1 mills to 28.5 mills. Residents living in areas that have higher than average millage rates will receive greater relief for any given income level; likewise those living in areas with lower than average millage rates will receive less property tax relief.

Furthermore, the table does not estimate the loss of city income tax credits to individuals who live or work in one of the 16 cities that levy an income tax,

EXHIBIT 4: 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

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

EXHIBIT 5: Effects of Proposed Tax Changes

Baseline Categories	Renters		Seniors		Homeowners			
Income level	$15,000	$30,000	$10,000	$20,000	$30,000	$50,000	$100,000	$200,000
Home value/annual rent	$6,000	$8,400	$50,000	$65,000	$75,000	$100,000	$150,000	$300,000
Taxable consumption	$6,900	$11,250	$4,800	$8,600	$11,250	$16,000	$24,500	$40,000
Tax consumption/income (%)[1]	46.0%	37.5%	48.0%	43.0%	37.5%	32.0%	24.5%	20.0%
Proposed Tax System								
Property tax (28.5 mills)	$1,020	$1,428	$713	$926	$1,069	$1,425	$2,138	$4,275
Homestead credit[2]	0	0	–450	0	0	0	0	0
Sales tax (6%)	414	675	288	516	675	960	1,470	2,400
Federal deductibility	0	0	0	–139	–160	–399	–663	–1325
Total taxes	$414	$675	$551	$1,303	$1,583	$1,986	$2,945	$5,350
Changes in individual taxes paid								
Property tax	0	0	–$738	–$959	–$1106	–$1475	–$2213	–$4425
Homestead credit[3]	$297	$227	650	1,185	675	690	0	0
Sales tax	138	225	96	172	225	320	490	800
Federal deductibility	0	0	0	–34	65	220	686	1,372
Total change in taxes paid	$435	$452	$8	$364	–$142	–$245	–$1,037	–$2,253
Other								
Transfer tax: 4% of home value	na	na	$2,000	$2,600	$3,000	$4,000	$6,000	$12,000
Nonhomestead property[4]	na	na	$2,000	$2,210	$2,550	$2,880	$4,140	$8,280

SOURCE: Public Sector Consultants, Inc.

[1]Taxable consumption and its share of income are estimated from the 1991 *Consumer Expenditure Survey* of the Bureau of Labor Statistics.
[2]New homestead credit is $450 for seniors living below 150 percent of the poverty level (approximately $12,000).
[3]Old homestead tax credit was limited to $1,200 and phased out for incomes greater than $73,650.
[4]16-mill tax paid in lieu of transfer tax. Value shown is tax paid for five years net federal deductions. A homeowner could pay the 16-mill tax as little as three years to avoid the transfer tax.

na = not applicable

a loss that would fall in the $25–$50 range for most taxpayers. The effect of the cigarette tax increase on the roughly 25 percent of the population that smoke also was not included. A person who smokes one pack daily will pay about $180 a year in higher cigarette taxes.

As a result of the proposed changes, nonsenior homeowners' tax bills will decrease, and high-income earners with high-value houses will benefit more than those of more modest means. Currently, high-income individuals do not benefit from the homestead property tax credit, so they are unaffected by its elimination under the new system. Hence, they receive the full benefits of property tax reductions until they sell their house and pay the transfer tax.

Those homeowners who currently qualify for the homestead credit will have some of their property tax relief offset by higher income taxes due to reduced property tax credits. For instance, a family with an annual income of $30,000 living in a house valued at $75,000 currently deducts $675 from their income tax bill for the homestead credit. Under the proposed plan, their assessed property tax bill will go down by $1,106, but they will no longer deduct $675 from their state income tax bill—so their net property tax relief amounts to $431.

Nonseniors who own homes will see their annual combined tax bills drop unless they sell their home or purchase a car, which would substantially increase their sales tax burden. Senior citizens who own homes, however, will likely see their combined tax bills rise. Two forces are at work here: (1) at present, seniors receive a more generous homestead tax credit than other taxpayers, and (2) as low income taxpayers they spend a larger portion of their incomes on taxable consumption. Due to their lower incomes, many seniors are able to claim the entire $1,200 homestead credit under the current system. Unless they live in a high-value home, the homestead credit loss will exceed the property tax relief under the proposed changes.

For instance, the senior taxpayer with a $20,000 income who lives in a $65,000 home previously paid $1,885 in property tax and received a $1,185 homestead credit. If the current tax credit program is maintained, this taxpayer would pay $926 in property tax and receive a $226 homestead credit—both values would drop by $959. The proposed program, however, eliminates the homestead credit for this taxpayer, so while their property tax decreases by $959, they lose the entire $1185 credit and end up paying an additional $226 in net property taxes. In addition, this net property tax increase will add to an increased sales tax burden that hits lower-income families harder than others because the sales tax is regressive. Low-income seniors, however, will benefit from the proposed $450 credit.

Finally, we consider renters. Exhibit 5 shows that all renters are likely to pay higher taxes under the new system because they receive none of the benefits of property tax relief but must give up the associated homestead credit. Renters would benefit if reduced property taxes lead to reduced rental rates, but this is not likely to happen because rentals will be subject to a proposed 16-mill tax on nonhomestead property. Landlords will see only a small drop in property taxes, which we assume they will pocket.

Renters will be hit in another way, too. When those who currently rent decide to buy a home, they will pay more for that home because of the proposed transfer tax which we assume will be shared by both sellers and buyers, although the tax likely will be levied on the seller.

TAX POLICY CONSIDERATIONS

Is the governor's proposal good tax policy for the state? Overall the answer is no, but some of the changes are good. First—and most important—the plan improves the balance of the state tax system. Currently, Michigan overuses the property tax and underuses the sales tax, with a property tax burden about 30 percent above the national average and a sales tax burden 30 percent below the national average. Implementation of the proposed changes will put Michigan near the national average for both sales and property taxes.

Second, extending the cigarette tax to all tobacco products corrects the current inequity of taxing only cigarette tobacco. Finally, providing a $450 credit for low-income (up to 150% of the poverty level) seniors improves the equity of the system by offsetting the regressiveness of the sales tax for these seniors. *A strong case can be made for expanding this credit to all low-income people, but the cost would be high, and the state would have to find additional revenue sources.* This credit however, is particularly important to seniors, because many will not receive a significant net property tax reduction due to the elimination of the generous homestead tax credit.

The major problem with the governor's proposal is that it relies on several regressive, unstable taxes. First, although a strong case can be made for increasing the sales tax because it is underused and less unpopular with voters than other major taxes, it is regressive, is not deductible for federal tax purposes, and grows slower than the economy. In contrast, the income tax is progressive, is deductible for federal tax purposes, and grows at a faster rate than the economy.

The governor claims that an income tax will hurt the economy. We dispute this claim. Twenty-two states have higher income taxes than Michigan *and* still have lower unemployment rates (see Exhibit 6). Minnesota, for example, has income tax rates of 6 percent to 8.5 percent, yet consistently has had higher economic growth than Michigan and many other states with lower income taxes. *We favor increasing the income tax rate from 4.6 percent to 6 percent in lieu of asking the voters to increase the sales tax. An option would be first to raise the income tax and then give voters the choice to substitute a sales tax increase.*

Second, the property transfer tax (whether paid by the buyer or seller) is an unstable, inequitable tax. A 4 percent tax on real estate transfers will be the second highest transfer tax in the nation, second only to Pennsylvania. The tax will hit low-income taxpayers much harder than high-income taxpayers, as shown in Ex-

EXHIBIT 6: Comparison of State Income Tax Rates and Unemployment Rates

State	Income Tax Rates	Income Level, Highest Rate	Income Level Rate Exceeds Michigan	Unemployment Rate, July 1993	Personal Income Tax, Percent of Personal Income, FY 1990–91
Alabama	2–5%	$3,000	$3,000	7.6%	2.0%
Alaska	0			7.9	0.0
Arizona	3.8–7	150,000	25,000	5.5	2.1
Arkansas	1–7	25,000	15,000	5.6	2.4
California	1–11	207,200	17,000	9.8	2.7
Colorado	5			5.3	2.4
Connecticut	4.5			6.5	0.6
Delaware	3.2–7.7	40,000	5,000	4.8	3.5
Florida	0			7.0	0.0
Georgia	1–6	7,000	5,250	5.2	2.7
Hawaii	2–10	20,500	2,500	4.7	3.8
Idaho	2–8.2	20,000	3,000	6.2	2.9
Illinois	3			7.2	2.0
Indiana	3.4			4.5	2.7
Iowa	0.4–10	47,700	4,240	4.0	2.9
Kansas	4.4–7.75	30,000	20,000	4.8	2.0
Kentucky	2–6	8,000	5,000	6.4	3.7
Louisiana	2–6	50,000	50,000	6.6	1.3
Maine	2.1–10	37,500	4,150	7.4	2.8
Maryland	2–6	100,000	3,000	6.7	4.1
Massachusetts	No tax on wages			6.3	3.9
Michigan	**4.6**			**7.3**	**2.5**
Minnesota	6–8.5	47,100	100	5.0	3.6
Mississippi	3–5	10,000	10,000	5.4	1.5
Missouri	1.5–6	9,000	7,000	6.0	2.3
Montana	2–11	59,000	6,800	6.1	2.4
Nebraska	2.37–6.92	27,000	16,800	2.7	2.2
Nevada	0			6.6	0.0
New Hampshire	No tax on wages			6.2	0.2
New Jersey	2–7	75,000	35,000	6.9	1.7
New Mexico	1.8–8.5	41,600	15,600	7.2	1.7
New York	4–7.9	13,000	5,500	7.5	4.4
North Carolina	6–7.75	60,000	100	4.5	3.2
North Dakota	14	federal tax		4.3	1.2
Ohio	0.7–6.9	100,000	40,000	6.9	3.2
Oklahoma	0.5–7	9,950	6,200	6.3	2.6
Oregon	5–9	5,000	100	7.8	4.1
Pennsylvania	2.95			6.6	2.4
Rhode Island	27.5	federal tax		6.6	2.3
South Carolina	2.5–7	10,600	6,360	7.2	2.6
South Dakota	0			2.7	0.0
Tennessee	No tax on wages			5.6	0.1
Texas	0			7.2	0.0
Utah	2.5–7.2	3,750	2,250	3.9	2.9
Vermont	28–34	federal tax		5.4	2.6
Virginia	2–5.75	17,000	5,000	5.7	2.6
Washington	0			8.6	0.0
West Virginia	3–6.5	60,000	40,000	10.0	2.3
Wisconsin	4.9–6.9	15,000	100	4.8	3.5
Wyoming	0			6.4	0.0
United States				6.8%	2.4%

SOURCE: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Washington, D.C., 1993.

NOTE: Michigan ranks 23 in terms of personal income tax collections as a share of personal income.

hibit 7, and this regressiveness will not be offset by tax credits, as has been the case with the property tax.

In addition, the transfer tax will impose a larger burden on homeowners whose homes do not increase in value than on homeowners with large capital gains. Although the tax will go up as the home value increases, the tax will only reduce the profits of those whose home increases in value, while possibly resulting in a loss for those homeowners living in areas where housing values are stagnant. Another major problem is that this tax is very unstable. Because housing is very sensitive to economic activity, it could rise 25 percent or more one year and fall 25 percent or more the next year. *If this tax is enacted it should be tied to a stabilization fund so that money is put away in good years to be used when revenues decline sharply.*

A third disadvantage is that the tax could hurt the real estate market by making it more difficult for first-time home buyers to purchase a home. Many young families buying their first home often have difficulty saving enough money for a down payment. Increasing their costs by $4,000 for a $100,000 home will reduce the number of families able to afford a home. We believe this argument is valid whether the tax is imposed on the seller or the buyer. Clearly, the tax will be a negotiable item in the price, and the seller, where possible, will increase the asking price to compensate for the transfer tax.

We understand the political advantage of the transfer tax—it allows a large net tax cut for the 90 percent to 95 percent of homeowners who do not move each year, while still allowing most of the revenue lost under P.A. 145 to be replaced. This is not unimportant; however, a better choice is available. *We recommend that the seller of a home be required to pay a tax on the increase in the value of their home.* This tax could still raise the cost of some homes for buyers, but someone whose house has gained a lot in value might be more willing to bargain on the selling price than someone whose house has lost or gained little in value. This tax also would be fairer to people who live in areas where housing values are not increasing, which are generally low-income areas where the homeowners are less able to pay taxes.

Finally, the proposed elimination of state revenue sharing is a step backward. The stated reason for this elimination is that revenue sharing provides an incentive for local governments to raise property taxes. It does not appear that revenue sharing has been driving up millage rates. From 1972 to 1992 the average millage rate statewide increased by about 7.25 mills. The millage rate for schools increased by 9.24 mills, while the rate for other governments declined by about 2 mills, probably, in part, because of Headlee millage rollbacks.

The main purpose of revenue sharing is to help equalize the revenue-raising ability of local govern-

EXHIBIT 7: Effective Real Estate Transfer Tax Rates at Various Income Levels: 1983

Household Income (dollars in thousands)		Median	Property Transfer	Effective
Census Classes	Midpoint	House Value	Tax 2 Percent	Tax Rate (percent of income)
Less than $3	$2.5	$43,000	$860	34.4%
$3–7	5.0	35,900	718	14.4
$7–10	8.5	41,600	832	9.8
$10–15	12.5	45,300	906	7.2
$15–20	17.5	48,200	964	5.5
$20–25	22.5	52,500	1,050	4.7
$25–35	30.0	61,400	1,228	4.1
$35–50	42.5	73,300	1,466	3.4
$50–75	62.5	90,100	1,802	2.9
$75 +	100.0	128,500	2,570	2.6

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Annual Housing Survey: 1983*, Part C, Financial Characteristics of the Housing Inventory.

NOTE: The effective tax rate is a relative measure of the tax burden that relates taxes paid to income.

ments and to *reduce* the need for increases in local property taxes. The elimination of revenue sharing will require an average statewide increase of about 4.5 mills, but those jurisdictions with lower per capita property values will be required to levy a higher tax rate than those with higher property values because property assessment—on which millage is based—are lower in these jurisdictions.

Eliminating revenue sharing, however, allows the state to stay under the state revenue limit. Retaining revenue sharing would require an increase in some other state tax, pushing the state right up against the revenue limit or it would require the imposition of higher local taxes. Greater reliance on local option school millages, as we propose below, would solve this dilemma.

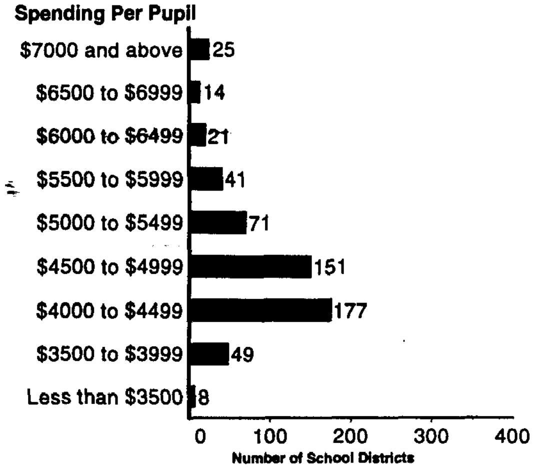
An advantage to dropping this provision is that it would mean one less provision would be needed in the constitutional amendment. As mentioned earlier, the governor has indicated a willingness to restore revenue sharing for cities, likely requiring that additional revenues be raised by levying local property taxes.

DISTRIBUTION OF FUNDS

The governor is proposing a basic change in the method of equalizing school district resources. Currently, the state uses a "power equalizing" formula that guarantees each school district a minimum amount per pupil based on the millage rate levied by the district. This formula does help equalize resources, but it still leaves a wide gap among districts for several reasons.

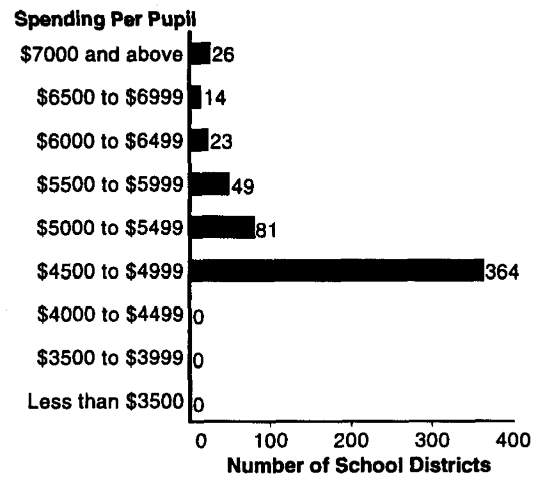
First, voters in some districts are more willing to vote millages than in other districts. Second, districts that raise more money locally than the amount of the state guarantee have generally had above-average growth in their tax base, widening the gap between them and districts dependent on state support.

EXHIBIT 8: Current Spending Per Pupil, by School District



SOURCE: *Our Kids Deserve Better! New Schools for a New Century. Governor John Engler's Plan to Reform Michigan Schools.* October 5, 1993, p. 38.

EXHIBIT 9: Proposed Spending Per Pupil, by School District



SOURCE: *Our Kids Deserve Better! New Schools for a New Century. Governor Engler's Plan to Reform Michigan Schools.* October 5, 1993, p. 38.

The governor's plan will provide every district with a minimum per pupil foundation grant of $4,500 up to a maximum of $6,500 that will not depend on local voter action and that will increase as state revenue earmarked for schools increases. (See exhibits 8 and 9). The grant will include all current categorical payments except special education, adult education, and a school readiness program, plus all retirement payments.

Districts wanting to spend more than $6,500 will be required to levy local millage, but their revenues would not be allowed to increase faster than the rate of inflation. Consequently, approximately 40 districts will need to levy local millages, ranging from less than one mill in two districts to over 10 mills in each of two districts, 10.83 mills in Southfield and 11.28 mills in Bloomfield Hills.

The new distribution formula will reduce significantly the disparity in resources by bringing up the poorer districts and limiting growth in the richer districts. Exhibit 10 shows what will happen to a district with resources of $5,500 per pupil and a district with resources of $7,000 per pupil over time, assuming an inflation rate of 3.5 percent and state revenue growth of 5 percent.

EXHIBIT 10: Comparison of Projected Revenue Growth in Two Districts Under Governor's Proposal

Year	District A	District B
1	$5,500	$7,000
2	5,775	7,245
3	6,064	7,499
4	6,367	7,761
5	6,685	8,033
6	7,020	8,314
7	7,371	8,605
8	7,739	8,906
9	8,126	9,218
10	8,532	9,540
11	8,959	9,874
12	9,407	10,220
13	9,877	10,577
14	10,371	10,948
15	10,890	11,331
16	11,434	11,727
17	12,006	12,138
18	12,606	12,563

SOURCE: Public Sector Consultants, Inc.

After 18 years the $5,500 district will be spending more than the $7,000 district. It is not clear what will happen at that point, but we assume that both districts would then be covered by the state grant and that the $7,000 district would no longer need to levy a local millage rate. The payment to both districts would then increase at the same rate—the growth in state revenues earmarked for schools.

A major advantage is that school districts will no longer have to spend time on millage votes. Supporters of local control may not view this as a positive, but it will provide stability for districts and allow administrators and teachers to concentrate their efforts on educating kids.

There are, however, two major problems with the governor's proposal. First, the foundation grant is not adjusted for regional cost differences. The result is that while the plan distributes resources more equitably, it does not do the same for resources, which means that equity is still a problem in terms of educational services because educating a child in Southeast Michigan is more expensive than educating a child in the Upper Peninsula (see Exhibit 11). A $4,600 grant per pupil statewide will buy only 74 staff members per 1,000 students in the Oakland ISD, while the same grant will buy 114 staff members per 1,000 students in the Menominee ISD. The average teacher salary is $46,623 in the Oakland ISD and only $30,292 in the Menominee ISD. This reflects, in large part, differences in the cost of living.

Second, the differences in spending levels of districts that spend between $4,500 and $6,500 in FY 1993–94 are permanently frozen, with the lower spending districts having no opportunity to catch up regardless of local preference.

Exhibit 12 presents the proposed K–12 expenditures for FY 1994–95. The Senate Fiscal Agency has estimated that spending will be $176 million higher and that the governor's proposal is underfunded by $116 million. These numbers, however, are not worth worrying about as the legislature will make numerous changes that will affect the bottom line significantly. In the final analysis the governor and the legislature will, it is hoped, agree on a proposal that will be fiscally balanced, at least on paper.

We recommend that the per pupil grant level be from $4,000 to $6,000, based on a cost of living index calculated for each ISD. The easiest way to calculate the index would be to use teachers' salaries, but other factors, such as utility costs, also could be included. Districts with revenue per pupil in excess of $6,000 would have the option of levying a local millage.

An alternative would be to lower the foundation grant and allow each ISD or group of ISDs to levy up to 6 mills, with voter approval. The state would provide an equalization guarantee of $150 per mill. Districts that needed additional revenue would have the option of asking voters for additional millage or an income tax, which also could be equalized by the

EXHIBIT 11: Differing Per-Pupil Costs of Education in Michigan

Intermediate School District	Expenditure Per Pupil	State Adjusted Staff*	Average Teacher Salary
Oakland	$5,741	74	$46,623
Washtenaw	5,530	79	43,720
Midland	5,102	77	45,041
Wayne	5,025	76	45,235
Macomb	5,007	73	47,418
Ingham	4,967	81	42,843
Kent	4,659	83	41,362
Kalamazoo Valley	4,578	94	36,528
Genesee	4,518	81	42,365
Charlevoix-Emmet	4,288	92	37,453
Berrien	4,287	96	35,976
Livingston	4,286	83	41,436
Calhoun	4,257	95	36,230
Muskegon	4,257	90	38,134
Ottawa	4,230	86	39,926
Saginaw	4,224	84	41,213
St. Clair	4,179	84	41,184
Monroe	4,179	86	40,062
Jackson	4,134	90	38,172
Eastern UP	4,133	107	32,277
Gogebic Ontonagon	4,117	106	32,448
Mason-Lake	4,057	93	37,179
Clinton	3,976	92	37,550
Eaton	3,968	88	39,271
Gratiot-Isabella	3,939	92	37,483
Traverse Bay	3,913	97	35,618
Marquette-Alger	3,894	102	33,704
Lenawee	3,875	92	37,575
Bay-Arenac	3,800	85	40,619
Shiawassee	3,791	86	40,336
Lapeer	3,789	81	42,832
Huron	3,740	101	34,167
Manistee	3,728	102	33,820
Barry	3,717	90	38,446
Delta-Schoolcraft	3,700	94	36,781
Cheboygan	3,695	103	33,348
Ionia	3,671	97	35,738
Copper Country	3,670	105	32,957
Iosco	3,646	99	34,762
Alpena-Montmorency	3,646	97	35,444
Allegan	3,637	107	32,360
Hillsdale	3,633	102	33,970
Montcalm	3,616	100	34,659
COOR	3,606	105	32,792
Van Buren	3,591	102	33,814
Clare-Gladwin	3,582	101	33,995
Cass	3,560	108	31,913
St. Joseph	3,557	99	34,891
Tuscola	3,547	93	37,060
Oceana	3,529	106	32,673
Newaygo	3,529	91	37,834
Wexford-Missaukee	3,522	104	33,091
Menominee	3,504	114	30,292
Sanilac	3,474	98	35,096
Dickinson-Iron	3,472	107	32,376
Mecosta-Osceola	3,444	99	34,955
Branch	3,425	97	35,674
Michigan	**$4,607**	**83**	**$41,490**

SOURCE: Michigan Department of Education. Calculations by Public Sector Consultants, Inc.
*The number of staff members per 1,000 students that can be hired, given a $4,600 grant per student.

EXHIBIT 12: Proposed K–12 Spending, FY 1994–95

Category	Amount
$4,500 foundation grant	$7,182
Hold harmless ($4,500–$6,500)	1,176
Special education, adult education, and preschool	908
Local spending (Detroit)	190*
TOTAL	$9,456

*The governor has agreed to drop this provision, which reimburses Detroit for elimination of revenue sharing payments.

state but at a lower amount than the regional millage. (This recommendation will be discussed in more detail in a forthcoming *Commentary.*)

SUMMARY

We believe the governor has submitted a responsible proposal to the legislature that provides a solid starting point for debate. As with almost any proposal, some areas can be strengthened, as we have outlined above.

The major problem we have with the governor's plan is his recommendation to submit a complex constitutional amendment to the voters in February with no contingency plan. Voters may approve the amendment, but history is not on the governor's side. In November 1992 the voters defeated a simple cut in property taxes with no shift to other taxes. If powerful interest groups—such as the Michigan Education Association, the United Auto Workers, and the out-of-formula school districts—oppose the proposal, its chances of passage will not be good.

We recommend that the income tax be increased to 6 percent, which would raise the same $1.8 billion as a 2-cent increase in the sales tax, and that the voters be given the opportunity to replace the income tax with the sales tax. In addition, the amendment should be simplified by dropping provisions that are not absolutely essential, such as abolishing the State Tax Commission and reforming the State Board of Education.

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