

K–12 Funding

BACKGROUND

After 25 years of futility and 12 ballot proposals, in 1994 Michigan revamped the way it funds K–12 education: Voters said yes to Proposal A, which put in place a 2-cent sales tax increase and generated revenue from several smaller sources (including a state property tax), to replace about two-thirds of the local school property tax. (Actually, school property taxes were reduced by only about 50 percent, because the proposal also instituted a 6-mill state education tax.) The legislature had approved the package in 1993 and given the voters only one choice: whether to replace the property tax with the income tax or the sales tax. In every previous vote, voters had been able to choose between a new system or the current one, and in every case they had opted for the old, however much they disliked it.

Exhibit 1 presents a comparison of the old and new school finance systems. The two key provisions (1) replace most school property taxes with the sales and other taxes and (2) adopt a minimum “foundation” grant of \$5,000 for all school districts—that is, the state gives all districts at least \$5,000 for each pupil. The foundation grant has increased to \$5,462 per pupil for FY 1998–99.

Goals of Reform

The new system has five major objectives.

- Reduce property taxes, which had been about 35 percent above the national average. Proposal A reduced *total* school property taxes by about 33 percent (26 percent after accounting for loss of state property tax credits). For homeowners, the cut was 42 percent (32 percent after the loss of state tax credits); for the roughly 30 percent of taxpayers who itemize for federal tax purposes, the reduction was smaller. For businesses, the property tax cut was about 13 percent.
- Reduce reliance on local millage votes to provide school funding.
- Increase the state share of total revenue for K–12 education. In 1993 the state contributed only 32 percent (ranking Michigan 48th among the 50 states), which meant that two-thirds of K–12 revenue had to be generated locally, and this was a major reason for the heavy property tax burden and also the unequal distribution of resources among districts. Under the new system, the state picks up about 80 percent of the total cost, moving Michigan up to 2d among the states.
- Assure all local districts a minimum level of per pupil revenue, in part to permit them to institute such education reforms as establishing a core aca-

GLOSSARY

Categorical funds

Funds appropriated for a specific purpose—e.g., school transportation.

Foundation grant

The minimum amount appropriated for every public school child in the state.

Homestead property

A property taxpayer's principal residence.

Mill

A monetary unit equal to 1/1000 of a dollar. Millage is the tax rate on property—the number of mills assessed against the property's taxable value.

Nonhomestead property

A secondary dwelling such as a vacation home or a business.

State equalized valuation (SEV)

In Michigan, 50 percent of a property's market value.

EXHIBIT 1. Comparison of Former and New School Finance Systems

<i>Revenue Source</i>	<i>Former System</i>	<i>New System</i>
Property tax		
Operating mills	6–45 local	6 state (all property) 18 local (nonhomestead) 3 enhancement (all property, ISD wide) Hold-harmless additional mills (35–40 districts)
Debt mills	Locally determined	No change
Assessment cap	None	5% or inflation, whichever is less, until sold
Sales tax	2.4%	4.4%
Use tax	None	2%
Cigarette tax	2 cents per pack	47.5 cents per pack
Other tobacco products	None	16% of wholesale price
Property transfer tax	None	.75%
Income tax (earmarking) ^a	None	23%
Lottery	All profits	No change
Interstate telephone tax	None	6% (2% to School Aid Fund; 4% to GF)
GF/GP grant to schools	Legislatively determined	No change
School aid formula	\$400+\$102.50 per mill per pupil Average grant: \$3,825 Annual amount determined by legislature 60+ categoricals: transportation, retirement, Social Security	Foundation grant: \$4,200–5,000 to \$6,500; tied to growth in school aid revenue (initially), with low-spending districts increasing at higher rate Limited number of categoricals; at-risk ^b categorical added: \$230 million

SOURCE: Public Sector Consultants, Inc.

^aThe reform lowered the state income tax rate from 4.6 percent to 4.4 percent.

^bFor children at risk of academic failure.

demic curriculum and achieving school accreditation.

- Reduce interdistrict disparities in per pupil revenue. In 1994 local per pupil expenditures ranged from \$3,277 to \$10,356; the disparity was because of the difference in revenue-raising capability (that is, the value of property) among districts.

Results to Date

In many ways, Proposal A has achieved most of its original objectives.

- First, it has largely settled an issue—school finance reform—that had festered for 25 years and consumed the time and energy of legislators, state officials, school officials, association representatives, and many others.
- Second, reducing the property tax and capping assessment increases has significantly defused taxpayer anger about property taxes, and to some

extent this reduces taxpayer dissatisfaction with state and local government.

- Third, Proposal A has reduced the gap between the highest- and lowest-spending districts; the ratio of highest to lowest is estimated at roughly 2 to 1 for FY 1997–98 (narrowed from more than 3 to 1 in 1993–94, the last year under the old system). The highest-spending districts include Bloomfield Hills, Birmingham, Grosse Pointe, Troy, Ann Arbor, and Midland; the lowest generally are rural areas and small towns. Under Proposal A, the wealthier (highest-spending) districts are receiving the smallest increases in state funding, and the poorer (lowest-spending) districts are receiving the largest.

As shown in Exhibit 2, Proposal A has significantly boosted resources for the lowest-spending districts. The first column shows the average cumulative growth rate since FY 1993–94, and the fifth quintile

(20 percent of all districts—the roughly 105 lowest-spending) have received an almost 16 percent hike; their per pupil amount, from all income sources, still is considerably less than in wealthier districts, but the gap is narrowing. There is a correlation between the increase and enrollment: The average current enrollment for the fifth quintile is only about 1,500, while for the first quintile (the wealthiest districts), it is more than 4,000. There also is a high correlation between the increase in revenue and property value (state equalized evaluation, or SEV) per pupil: for homestead property, the fifth quintile's SEV per pupil is under \$40,000; the first's is almost \$100,000 (the state average is approximately \$63,000).

For nonhomestead property, the fifth quintile's SEV per pupil is about \$36,000, but the first's is \$96,000 (the state average is \$53,000). In the 45 highest-spending districts—now subject to the slowest growth rate in resources—there is a heavy concentration of wealth: The average SEV per pupil in these districts is \$108,000 for homestead property and \$142,000 for nonhomestead.

These data raise some interesting questions, which will be answered over time. First, since 1993–94, 89 school districts have received average annual revenue increases exceeding 5 percent, which is well above the average inflation rate (2.8 percent) for the period. In

1993–94 the poorest districts were spending less than \$3,000 per pupil, but now they are spending a minimum of \$4,816 per pupil (foundation grant only). What have these districts done with this money, and have they spent it efficiently? (Some of this money has been used to support larger pay increases for teachers, but the numbers are not dramatic.) Second, 80 districts (the highest-spending) have received annual revenue increases of 2 percent or less. Their 1996–97 average per pupil revenue (foundation grant plus the categorical for at-risk pupils) is \$7,243, 26.5 percent above the state average of \$5,726. However, if their resources continue to increase at a rate below that of inflation, what are the implications for the quality of the education they offer?

DISCUSSION

The critical moment will come for the new finance system when the Michigan economy experiences another recession. In the past 30 years there have been five national recessions, and, on average, Michigan has been hit harder than the nation each time. There is some reason to believe that the state economy now is less vulnerable to economic downturns than in the past, and that these downturns will be less frequent. However, it is unrealistic to expect that recessions are a thing of the past, and it is almost certain that economic downturns will be harder

EXHIBIT 2. Growth in Foundation Grant and At-Risk Categorical Funds, All Michigan K–12 Districts, FY 1993–94 to FY 1996–97

	Average Cumulative Growth Rate	FY 1996–97 Annual Growth Rate	FY 1996–97 Revenue per Pupil	Average Enrollment	FY 1996–97 SEV per Pupil	
					Homestead	Nonhomestead
First quintile ^a	5.3%	1.7%	\$6,876	4,375	\$97,510	\$96,434
Second quintile	7.9	2.6	5,849	2,824	62,506	59,204
Third quintile	11.2	3.6	5,611	3,313	55,115	37,756
Fourth quintile	14.0	4.5	5,339	3,470	56,967	33,931
Fifth quintile	15.7	5.0	4,659	1,484	38,765	35,787
45 lowest-spending districts (50% of average growth rate)	4.1	1.3	7,961	5,090	108,283	142,498
All K–12 districts	10.4%	3.3%	\$5,726	3,115	\$62,678	\$53,040

SOURCE: Michigan Department of Education; calculations by Public Sector Consultants, Inc.

^aQuintile = One-fifth of the total, roughly 105 districts. The first quintile comprises the districts that now are having the slowest revenue growth (they are the highest-spending districts); the fifth quintile comprises the districts, which under Proposal A are enjoying the fastest revenue growth (they are the lowest-spending districts).

on the revenue sources for the new School Aid Fund than they had been on local property tax revenue.

Problems with the New System

As stated above, the new financing system has been successful in achieving most of its objectives but not without some problems—some anticipated, some not.

Revenue-Source Growth

The new state School Aid Fund (SAF) was not expected to grow as fast as did the pool of money formerly generated by local property taxes, and, indeed, it has not. From FY 1994–95 to FY 1997–98, the SAF supported growth in the foundation grant from \$5,000 to \$5,462, an average annual increase of 3 percent, only slightly above the estimated inflation rate (2.8 percent). Local property tax assessments—but for being capped by Proposal A—would have increased at an annual rate (FY 1997–98 is estimated) of 7 percent.

Stability

During an economic turndown, the new funding system is expected to grow more slowly and be less stable than the old system.

- During the 20 years from 1972 to 1992, property tax assessments grew at an annual rate of 7.1 percent, while the replacement-revenue sources grew at a rate of 6.6 percent.
- During the most recent downturn (1989–92), however, property taxes increased at an annual rate of 8 percent, but the replacement revenue increased only 3.6 percent. For schools, the problem of slower revenue-source growth will be ameliorated somewhat if more of the state income tax is “earmarked” (dedicated) to the School Aid Fund; in 1996 the legislature set a precedent for increasing the share by raising it from 14.4 percent to 23 percent. The fact remains, however, that the new revenue sources, particularly the property-transfer and cigarette taxes, are not as stable as the property tax.

Local Revenue Raising

The new system restricts local revenue-raising ability. The provision to allow intermediate school districts (ISDs—special purpose units formed to enable

public schools within a geographic area to collaboratively provide services, e.g., special education, to the wider population) to ask voters to approve an ISD-wide millage of up to 3 mills may not be practical. The problem is that such approval too seldom will be achieved—in part because it will be difficult for the majority of the school districts in an ISD to reach consensus on the need for additional millage, and in part because some voters may not see a benefit if the new revenue is divided equally across the entire ISD.

Enrollment

The new state formula depends heavily on enrollment, and no provision is made to help districts where enrollment is declining. The old system didn’t either, but under it the district had the option of asking voters for additional millage to offset revenue lost due to an enrollment drop.

Categorical Funding

One key provision of Proposal A was to roll many of the categorical funds—e.g., transportation, retirement, FICA—into the foundation grant. This creates a number of problems for the districts. First, it increases legislative scrutiny of categorical grant spending, as evidenced by cuts in recent years in appropriations for adult education. Second, expenditures for these programs now must come out of the foundation grant monies instead of being paid for separately by the state. Third, eliminating the categoricals for teacher retirement and FICA is increasing the financial pressure on most districts because these expenditures are increasing faster than revenue; some observers view this provision of the reform as positive, however, because now districts must bear the full cost of the wage contracts they negotiate and cannot pass fringe-benefit costs to the state.

Regional Costs

The new system fails to address two longstanding shortcomings of the old system. One is that it fails to take into account regional cost differences of providing education: \$5,000 per pupil buys a lot more education in the Upper Peninsula than in southeast Michigan (for example, in 1994 salaries in the Oak-

land County ISD were 44 percent higher than in the eastern U.P. ISD).

Debt Millage

The second shortcoming common to both the old and new systems is that there is no provision for equalizing debt millage, which places low-property-value districts at a great disadvantage (for example, Birmingham can raise about \$270 per mill per pupil, while Detroit can raise only \$16).

Needed Reforms

Most fiscal experts do not believe that the new school finance system needs major change, but some tinkering could improve its fairness and flexibility.

Local Revenue Raising

The most obvious weakness is that local districts have no ability to raise operating revenue on their own. One approach would be to eliminate the ISD-wide millage option and allow each district to ask its voters for up to 2 or 3 mills. Opponents to this approach say it would be the beginning of a slow return to high local property taxation.

Enrollment

The new system provides adequate resources for districts where enrollment is going up, but where it is declining, districts will be hard pressed to keep up with rising costs—and under Proposal A they are prohibited from asking local voters for additional millage. An enrollment dip can be caused by demographic or economic factors as well as by losing students to charter schools or, as allowed under schools of choice, to other districts. Some say there should be little sympathy for a district that is losing pupils because of student/parent dissatisfaction with the education offered by the district, but others contend that there should be a “safety net” for districts that lose students because of local economic conditions or to specialized charter schools that can offer programs not offered in the local district.

Capital Spending

The new funding system has reduced the disparity among districts for operating funds, but it has done nothing to equalize capital spending. A district hav-

ing property value of \$200,000 per pupil can raise \$200 per pupil per mill, but a district with property value of only \$50,000 per pupil can raise only \$50 per pupil. The capital-spending inequality is critical because of districts’ need to upgrade buildings or construct new ones, to meet technology and/or enrollment demands and also to compete with charter schools and traditional schools trying to take advantage of the schools-of-choice plan. One solution is to base the amount each district receives from levying debt mills on the average ISD property value per pupil. Wealthier districts likely would object, because they would have to share their revenue with other districts in their ISD.

Regional Cost Differences

Some observers believe the school finance system would be improved by making some adjustment for the differential cost of education across the state. As mentioned above, it is much more expensive to educate kids in southeast Michigan than in the Upper Peninsula. The failure to make such an adjustment erodes the equalization of resources that Proposal A was designed to achieve. The easiest approach would be to develop a cost index for each ISD (or for larger regions), using teacher salaries as a proxy for the difference in costs. (Other goods and services, such as utilities and supplies could be included in the index, but this would complicate the process without much improving the outcome.) The index then would be used to adjust the foundation grant and possibly the categorical grants. For example, if the average state grant were \$5,000, a district with costs 10 percent below the state average would receive \$4,500 per pupil and a district with costs 10 percent above would receive \$5,500. Although it is possible that such an index could encourage districts to be less heedful of holding teacher salaries down, the size of the state School Aid Fund is going to be restricted by available revenue, and in lean years even an indexed grant could be insufficient to cover a district’s costs if they have been allowed to get too high.

The Future

Many school districts, because their experience to date is that the foundation grant has increased at about the rate of inflation, are concerned that the

new school finance system will not provide them with sufficient resources to keep up with the growing cost of providing a K-12 education (for example, increase teacher salary increases to keep up with inflation). The problem is exacerbated for districts receiving increases at a rate less than that of inflation. As shown in Exhibit 2, under Proposal A, the average annual increase for the quintile comprising the highest-spending (per pupil) districts has been only 1.7 percent. The increase for the quintile comprising the lowest spenders has been 5 percent, and this, of course, results in increased equalization of resources, which is one of the main purposes of Proposal A. Unfortunately, districts with revenue now growing more slowly than inflation have only very limited means to raise more revenue. Under the old system they could have asked the voters for more millage, and in many districts—particularly the more affluent—likely would have been successful, but that alternative is closed to them now. Their only option under the new system is to get ISD-wide approval for an increase of up to 3 mills. In most ISDs, such approval is unlikely.

Does this mean that many Michigan school districts face a permanent financial squeeze? Probably not. First, part of the reason that the increases to date in the foundation grant have been only modest is higher-than-projected enrollment increases, but we expect enrollment to level off soon and then begin to decline. The Michigan school-age population is expected to increase only 0.5 percent from 2000 to 2005 and then decline 2.5 percent from 2005 to 2010; the drop will be due largely to a reduction in the number of women in the childbearing age group.

Second, future revenue growth may be stronger than currently. Although the Michigan economy is strong, revenue growth is slowing as the recovery matures. The current recovery has reached 86 months, the third longest since World War II. If Proposal A had been enacted two years earlier, the initial increases in the foundation grant would have been well above the rate of inflation. Because of slower enrollment growth after 2000, we expect the increase in the foundation grant to average 4.7 percent from 2000 to

2005; the average increase from 1994-95 to 1997-98 was 3 percent. (These projections assume an average growth rate across a business cycle—no attempt is made to predict the next recession—and a 3 percent inflation rate. Enrollment is projected to stay about the same from FY 1999-2000 to FY 2004-05.)

There will, of course, be periodic slowdowns in the economy, when state revenue will grow more slowly than at present. It appears, however, because of structural (permanent) changes in the economy, slowdowns will be less frequent and less severe than in the past.

See also Casinos and Other Legal Gambling; K-12 Quality and Assessment; K-12 Schooling Alternatives; Personal Property Tax; State Government Debt.

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