Revenue Sharing

BACKGROUND

Michigan's revenue-sharing program began in the early 1930s and through numerous changes has evolved into the current system.

- In the 1930s the state began taxing enterprises holding licenses to sell alcoholic beverages; 85 percent of the revenue was returned to cities, villages, and townships. Later a portion of the intangibles tax revenue was added to the revenue-sharing pot.
- In 1946 a portion of the state sales tax revenue also was earmarked (dedicated) for local government.
- The 1963 state constitution (Article IX, section 10) expanded the locals' share of state sales tax revenue, dedicating one-eighth of it to cities, villages, and townships.
- In 1967 the state income tax was enacted and 11.5 percent of the gross receipts allocated to local governments: 50 percent to county governments (the first significant unrestricted state aid to counties) and 50 percent to cities, villages, and townships. This and all the above were distributed on a per capita basis.
- In the 1970s there were several substantial changes, and the system took the form that existed until 1996. The most significant revision occurred in 1972 with Public Act 212, which, for the first time tied cities', villages', and townships' share of state income tax revenue to their relative tax effort (RTE). A unit's RTE is measured by comparing its property, income, and excise taxes to the statewide average of all local units. The rationale for this formula is that tax effort better measures local need than does population alone. Local governments have different needs for public services and different revenue-raising ability not directly related to population. (For example, Detroit has a higher crime rate than Troy, and therefore, has a greater need for police services; but to raise the same revenue per capita as Troy, Detroit also must levy higher tax rates because Detroit's property values are much lower than Troy's.)
- In 1974, following voter approval of the food/drugs exemption from the sales tax, the state constitution was amended, increasing the tax revenue earmarked for revenue sharing from one-eighth to one-fifth (raising the percentage of total sales tax revenue allocated to locals from 12 percent to 15 percent).
- In 1975 the single business tax (SBT) was enacted and part of the revenue directed into revenue sharing; a portion of the new revenue-sharing payments was based on RTE and, because one levy that the SBT replaced was the personal property tax on inventories (a local government

GLOSSARY

Earmark
Dedicate; in government budgeting refers to funds dedicated to a specific program or purpose.

General Fund
Funds over which lawmakers have allocation discretion; i.e., monies that are not dedicated by law or constitution to a specific purpose.

Revenue sharing
Program through which state revenue is distributed to local government units; in Michigan, locals may use it for any purpose.

Tax effort
Taxes levied by a unit of government; relative tax effort (RTE) *is a unit's tax effort measured against that of others.*

revenue source), a portion of it was based on the inventory taxes collected that year by local government. Also in 1975 the percentage distribution of the income tax revenue to (1) counties and (2) cities, villages, and townships was changed from 50-50 to 35-65; the adjustment reflected state takeover of county welfare costs.

In the 1980s and early 1990s there were periodic reductions in payments to deal with short-term state budget problems, and there were adjustments (to reflect changes in tax rates) in the percentage of the sales, income, and SBT tax revenue shared with local governments.

In 1996 there were two major changes in state revenue sharing—one having to do with the basis on which the funds are distributed and the other with the source of the funds.

- *Distribution* Public Act 342 of 1996 changed the revenue-sharing distribution formula, effective October 1, 1997 (the beginning of the state's 1997–98 fiscal year). (1) The amount paid under the *RTE* formula now is capped at the FY 1996–97 level, and any growth in that revenue source (primarily from the sales tax) will be distributed on a *per capita* basis. (2) A bipartisan revenue-sharing task force was established and is charged with recommending future changes in revenue-sharing sources or distribution. If the legislature fails to act on the task force's recommendations (due in March 1998, but at this writing the task force had not completed its work), in FY 1998–99 local governments will receive payments equal to that of the previous year; any growth that has occurred in the revenue source will go into in a revenue-sharing reserve fund that will be distributed when the legislature finally acts.
- *Source* Public Act 342 also changed the source of revenue-sharing funds, removing income tax and SBT revenue and replacing it with additional sales tax revenue; thus, virtually all revenue sharing now comes from sales tax revenue. This likely will slow the growth in revenue-sharing payments, because historically, revenue from the sales tax has grown more slowly than that from the income tax and SBT.

Exhibit 1 presents the recent history of state revenue-sharing payments to locals. Over this 16-year period from 1981 to 1997, state revenue-sharing payments grew 140 percent, while total state spending from state resources grew about 135 percent. Adjusted for inflation, the payments increased roughly 43 percent.

Exhibit 2 shows that cities receive the lion's share—well over half—the revenue sharing in Michigan; in contrast, villages receive a very small percentage. The exhibit also shows how important this money is to the budgets of the various types of government: On average, state revenue sharing makes up only about 10 percent of county general fund budgets, but it accounts for more than 40 percent of the townships' (FY 1994–95 data are used, which is the latest comparable information available).

In Michigan, revenue sharing largely is *unrestricted*—that is, the state imposes no constraints on how it is spent by the local government that receives it. The amount of unrestricted money that states share with local units varies widely nationwide, and Michigan is more generous than most. Michigan's unrestricted aid

- as a share of state *General Fund* expenditures is 4.4 percent (the national average is 2.6 percent); and
- as a share of *total* intergovernment aid (includes school aid and certain other payments) is 13.5 percent (the national average is 7.8 percent).

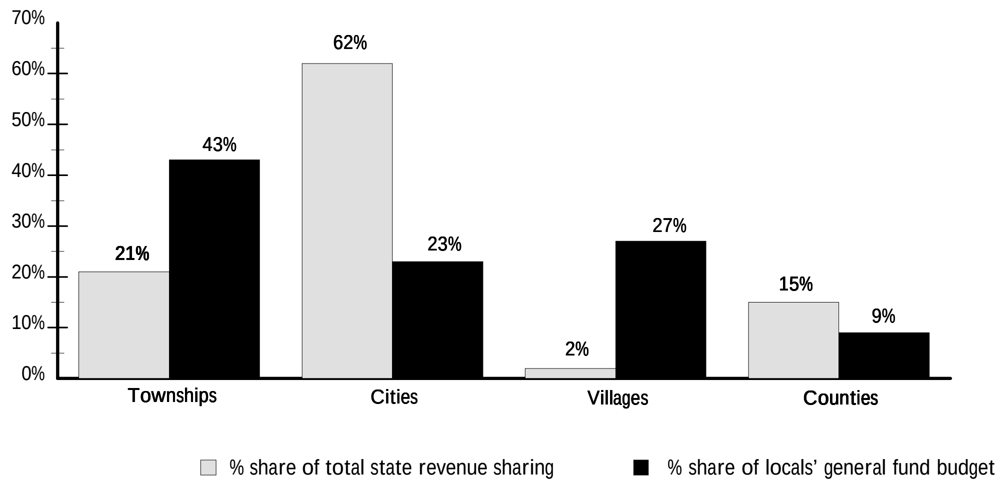
Most states, including Michigan, earmark revenue from a specific tax (most frequently, income and sales taxes) for revenue-sharing payments; a few also make General Fund appropriations.

EXHIBIT 1. State Revenue-Sharing Payments, FY 1980–81 to FY 1996–97 (millions)

		Income Tax		*SBT*				
Fiscal Year	*Sales Tax*	*Cities, Villages Townships*	*Counties*	*Relative Tax Effort*	*Inventory Payment*	*Intangibles Tax*	*Other*	*Total*
1981	$231.0	$101.8	$48.2	$56.6	$104.5	$0.0	$0.0	$542.1
1982	237.4	91.5	40.9	49.3	103.7	2.4	0.0	525.0
1983	243.6	122.9	65.1	60.9	102.6	0.0	0.0	595.1
1984	279.4	138.3	74.3	72.1	100.8	9.5	0.0	674.4
1985	308.2	156.7	84.2	99.9	101.7	9.5	0.0	760.2
1986	335.4	170.0	91.5	121.6	102.3	9.5	1.9	832.2
1987	345.4	182.6	98.3	136.2	102.8	9.5	2.9	877.7
1988	365.2	198.1	105.1	143.6	104.4	9.5	3.7	929.6
1989	385.3	214.0	113.5	160.6	106.6	9.5	4.0	993.5
1990	400.0	222.2	117.8	171.4	108.0	9.5	4.0	1,032.9
1991	400.6	218.1	115.7	166.3	107.1	9.5	0.0	1,017.3
1992	404.4	187.1	99.2	119.5	106.6	9.5	0.0	926.3
1993	424.2	224.1	121.6	153.5	109.1	0.0	0.0	1,032.5
1994	477.6	231.4	130.9	162.3	109.5	0.0	0.0	1,111.6
1995	477.0	249.1	143.6	191.9	107.4	0.0	0.0	1,169.1
1996	524.5	258.2	146.7	220.9	110.6	0.0	0.4	1,251.8
1997	535.6	264.4	159.1	226.2	111.9			
Percentage change	131.9%	159.7%	230.1%	299.3%	7.1%	NM	NM	140.4%

SOURCE: Senate Fiscal Agency.
NOTES: The 1996 and 1997 amounts listed for the income tax and SBT actually are paid from sales tax collections, due to a 1996 law change; they are presented to retain a consistent series.
NM = Not meaningful.

EXHIBIT 2. Revenue-Sharing Distribution and Portion of Local Budgets, Percentage Share, FY 1994–95



SOURCE: Senate Fiscal Agency.
NOTE: Figures may not total 100 because of rounding.

The basis on which revenue-sharing is distributed also varies widely among the states, but the formulae fall roughly into four categories: property tax reimbursement, population, tax effort, and origin.

- *Population* Funds are awarded on a per capita basis: e.g., number of people, per capita income, or urban population.
- *Tax effort* Help is given to those that help themselves. The state funding that a local receives is based on how much the local is taxing itself; this approach is used in many states.
- *Property tax reimbursement (or payment in lieu of taxes)* Funds are given to local governments to reimburse them for local tax revenue they have lost due to state legislation. For example, in Michigan the state reimburses locals for revenue they lost when the state repealed the personal property tax on inventory.
- *Origin* Funds are awarded in proportion to a local's contribution to state government revenue from a particular tax.

In FY 1994–95, before the major changes of 1996, Michigan distributed 53 percent of revenue sharing on the basis of population, 38 percent on tax effort, and 9 percent on the property tax reimbursement. Origin is not used in Michigan.

DISCUSSION

The main purposes of unrestricted revenue sharing are to

- equalize revenue among local governments, which have widely differing capability to raise revenue, and
- supplement the relatively limited revenue-raising ability of most local governments.

An alternative to revenue sharing is to give local governments access to revenue sources in addition to the property tax. For example, in Michigan, cities are allowed to levy up to a one percent income tax (up to 3 percent in Detroit). A drawback to this is that a jurisdiction that levies an income tax may be at a competitive disadvantage with neighboring jurisdictions without such a tax. A classic case is Detroit, which levies a 3 percent income tax (as well as high property taxes), needed partly because it has a low property tax base (that is, the value of its taxable property is low relative to other cities, in part because high city taxes have driven residents and businesses from the city—a vicious circle). A state revenue-sharing program allows local governments to levy lower taxes and mitigates competition among jurisdictions.

In the early years, revenue-sharing distribution was almost all per capita. In the 1970s, tax effort became accepted by public-finance experts and policymakers as the more equitable distribution basis. In the 1990s, however, per capita distribution once again has gained substantial support in the Michigan Legislature. One reason is that the legislative influence of Detroit and other older urban jurisdictions, which historically have received the lion's share of revenue sharing, has declined significantly. In FY 1994–95 Detroit received 25 percent of all unrestricted revenue-sharing payments ($292 million, or $285 per capita); in contrast, Grand Rapids received only 1.7 percent ($19.5 million, or $103 per capita). A shift to a formula based only on population will equalize per capita amounts in Detroit and Grand Rapids and reduce the disparity in payments. If a per capita formula ($126 per person) had been used in FY 1994–95, aid to Detroit would have been reduced by more than half and accounted for 11 percent of total revenue-sharing payments; aid to Grand Rapids would have increased almost a quarter and accounted for 2 percent of revenue-sharing payments.

One argument against shifting from tax effort to per capita is that such a shift exacerbates urban sprawl and migration from central urban areas. Reducing their revenue-sharing payments will require cities such as Detroit and Flint to raise taxes or reduce services, which will drive even more residents and businesses to suburban areas, where higher revenue-sharing payments will result in residents/businesses having lower taxes or more public services. This will encourage (1) the inefficient, costly practice of abandoning serviceable infrastructure (e.g., highways, sewer systems) in urban areas and duplicating this infrastructure in suburban and rural areas, and (2) continued development of land currently used for farming or recreation.

Supporters of per capita distribution of local aid argue that a tax-effort formula (1) deprives many jurisdictions of their fair share of state aid, (2) encourages local governments to raise taxes in order to get increased state aid, and (3) provides too much aid to Detroit.

See also Business Taxes; State-Local Relations.

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