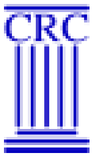

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CRC Memorandum

No. 1054 A publication of the Citizens Research Council of Michigan September 2000

Michigan's Unrestricted Revenue Sharing Program: Retrospect and Prospect

This Memorandum summarizes conclusions reached regarding the distributional aspects of new revenue sharing formulas and the prospects for the future for this important program. A companion analysis, Citizens Research Council Report #330 includes detailed quantitative analysis supporting the conclusions summarized in this memorandum and may be obtained on the CRC website (www.crcmich.org/publicat/2000s/2000/rpt330.pdf) or upon request.

The Citizens Research Council of Michigan revenue sharing project was underwritten by the generous support of the Hudson-Webber Foundation, the Herrick Foundation, and the Herbert and Grace Dow Foundation.

Background

The State of Michigan provides a broad range of financial support to its local units of government—cities, villages, townships, counties, school districts, and community colleges. Three-fifths of all state-levied taxes, fees, and other charges, almost $15 billion in Fiscal Year (FY) 2000, are paid to local units of government.

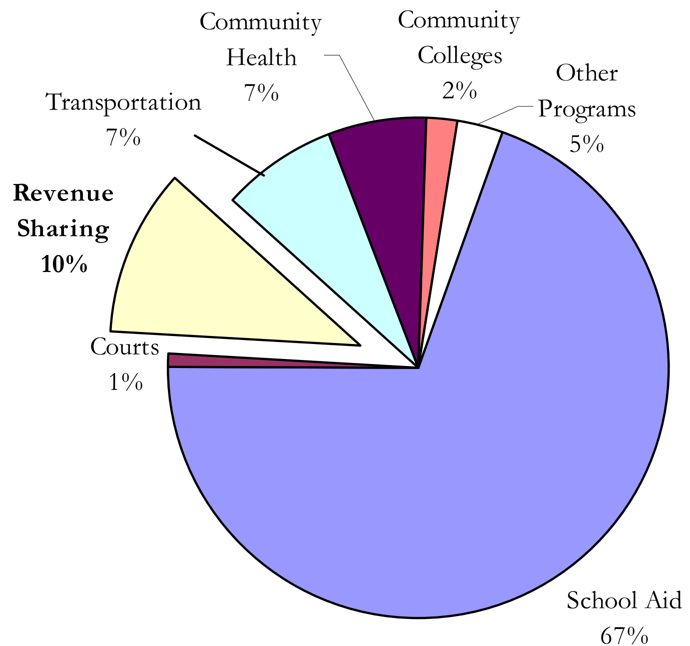
The second largest category of aid after School Aid, unrestricted revenue sharing, comprises shared state tax revenues that are distributed to cities, villages, townships, and counties based on formula calculations. The expenditure of these funds may support any programs the individual unit operates. Over 1,800 local units of government benefit from these revenue allocations, which, for many units, is their largest source of revenue. In FY2000, over $1.4 billion was appropriated for distribution to cities, villages, townships, and counties. These revenues are derived from 36.3 percent of the portion of the Sales Tax levied at a four percent rate.

Revenue sharing programs are defined generally as grant payments from one level of government to another. Every state in the United States has some form of revenue sharing program and every state except three makes payments to constituent local units without restrictions placed on the use of the payments by the recipients. The programs are usually justified on the basis of broad public policy goals: using equitable and efficient tax sources to finance public services, promoting property tax relief, and insuring a basic level of public services can be provided by each local unit.

Michigan's unrestricted revenue sharing program began in the early 1930s when 85 percent of Retail Liquor-License Tax collections were paid to cities, villages, and townships.

Revenue sharing payments for cities, villages, and townships equal a little less than half of the total amount of resident local taxes collected by those units. Revenue sharing is the largest single source of general operating revenue for many units. About one-fourth of all villages receive revenue sharing payments exceeding their property taxes and more than two-thirds of all townships fall into that category.

State of Michigan Shares of Total State Spending for Local Units of Government
Fiscal Year 2000



Source: CRC Calculations from Senate Fiscal Agency data.

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Milestones in Michigan's Unrestricted Revenue Sharing Program

Year	Event
1933	Unrestricted revenue sharing begins with liquor-license tax collections.
1939	Intangibles Tax is shared to offset loss of intangible property from local tax base.
1946	Constitutional amendment passes. State begins sharing one-half cent of Sales Tax with cities, villages, and townships.
1967	11.5 % of new State Income Tax shared. One-half goes to counties and one-half to cities, villages and townships.
1972	Distribution of city, village, and township Income Tax payments based on relative tax effort (RTE).
1975	Single Business Tax enacted and shared on RTE basis with cities, villages, and townships. Reimbursement of local revenue loss resulting from removal of business inventories from tax base begins.
1991	State discontinues Intangibles Tax distribution.
1996	State consolidates Income Tax and Single Business Tax shared revenues into an expanded percentage of the Sales Tax. Past revenue reductions in statutory allocations made permanent through lower Sales Tax percentage.
1997	At the beginning of FY1998, growth in the statutory payment allocation is made on a per capita basis. A legislative task force is charged with recommending changes in the statutory formula.
1998	Statutory formulas are repealed and replaced by new formulas with a ten-year phase in period.

Formulas

Following the enactment of new formulas in December 1998, CRC developed a detailed computer model permitting projections of payment amounts to be generated for the nearly 1,800 cities, villages, and townships in the state. As a derivative of the model, a calculator was placed on the CRC website permitting users to obtain projected payments as far into the future as FY2006 and permitting alternative estimates of the 2000 census population counts to be introduced into the analysis.

This material that follows summarizes conclusions reached regarding the distributional aspects of the new formulas and the prospects for the future for this important program.

Constitutional Payments

Michigan's Constitution allocates 15 percent of the State Sales Tax at a four percent rate to cities, villages, and townships. These payments are made on a per capita basis using population counts from the federal decennial census. Approximately 41 percent of the total payments going to cities, villages, and townships come from these revenues and the formula was not changed by the legislature in 1998 since it is constitutionally mandated.

Old Statutory Formulas

In FY1998, the final year of the old system, a three-part formula mechanism was used to allocate statutorily-defined shared revenues to cities, villages, and townships.

- $26 million was paid on a straight per capita basis using the 1990 federal census population.
- $80 million was distributed by multiplying the unit's tax rate by the inventory personal property tax base in the last year of the existence of the tax (1975). This formula was intended to compensate local units for the loss of that revenue source when the Single Business Tax was implemented. By 1998, the revenue sharing payments and the lost tax revenues arguably were not closely related.
- $492 million was paid on the basis of a population weighting scheme multiplying each unit's local tax effort rate divided by the state average times the unit's population. Units with high tax effort thus received greater payments through the weighting calculation. It was this component of the old formulas that was widely criticized for encouraging units to raise taxes and for distributing revenues disproportionately to urban areas, particularly those in southeast Michigan.

New Statutory Formulas

Beginning in FY1999, under Public Act 534 of 1998, a new set of three formulas began to affect the statutory payments. In that first year of implementation, ten percent of the statutory allocations were computed using the new formulas and 90 percent were based on the shares of statutory payments each unit received in FY1998. New formula shares increase by ten percentage points each year until the new formulas are fully operational. The phase-in mechanism is designed to create a pattern of gradual change in payments rather than the abrupt changes that would occur if the new formulas were implemented all at once.

The new formulas that will eventually replace the old statutory formulas are:

- **Unit Type.** One-third of payments are based on a population-weighting scheme that depends on the type of unit and its population size. The objective associated with this formula is that higher *per capita* payments should be made the more complex the form of government and the greater the population of the unit. The weights increase for the same population with the assumed complexity of the units. Within intervals of population size, the lowest weights go to townships and the weights increase for villages and further for cities. The weights range from 1.0 for townships with fewer than 5,000 people to 7.46 for cities with more than 160,000 population (Grand Rapids). Each unit receives a per capita share based on its weighted population. This weighting process results in a weighted population three and one-half times the actual population and significantly affects the distribution of revenue.

- **Inverse Taxable Value.** One-third of the payments are based on a population-weighting scheme computed by dividing the state-wide taxable value (TV) per capita by each unit's TV per capita and multiplying the result by the unit's population. The objective is to provide greater state aid for units with less taxing capacity, as measured by TV per capita. Each unit receives a per capita share based on its weighted population. The weighting calculation results in a weighted population about 20 percent above the actual population. Weights vary from nearly seven to less than one-tenth.

- **Yield Equalization.** One-third of the payments are based on a calculation that makes up the difference between the amount a local unit receives for each mill of tax rate (up to 20 mills) and a guaranteed minimum determined by the total amount of money available to distribute statewide. This formula is intended to provide greater state payments for units with lower taxing capacity and higher tax effort. Only units with TV per capita below the state-defined minimum receive allocations under this part of the formula.

City of Detroit—A Special Case

Allocations for the City of Detroit were removed from the mechanism for all other cities and the villages and townships. Statutory and Constitutional payments combined are frozen at $333.9 million per year from FY1998 through June 30, 2006. In exchange for this protection against declining payments resulting from the new formulas and the 2000 census, the city personal income tax rates are being reduced. A total reduction of one-third in the resident rate (from 3 percent to 2 percent) and non-resident rate (from 1.5 percent to 1 percent) will be accomplished over a ten-year period. The city also received a modification in state statute that will permit levying the Utility Users Excise Tax even if the city population falls below 1,000,000 in 2000.

The Overall Effects of the New Formulas

CRC has isolated the effects of the new formulas from other factors such as payment growth limits, the 2000 census, the ten-year phase in and revenue growth. The analysis makes calculations on the distributional effects that the new formulas create compared with the old formulas. The effects are dramatic. If the statutory formulas were implemented all at once, some unit statutory payment losses would exceed 80 percent and some gains would exceed 500 percent.

The distribution effects on the overall amounts going to cities, villages, and townships as a group are also significant. The share of total statutory payments allocated to cities drops from 78 percent to 70 percent. The township share increases from 18 percent to almost 26 percent and the village share rises from 3.5 percent to 4.1 percent of total statutory payments.

Current Payments-Constitutional

In FY2001, state appropriations for revenue sharing allocate $661 million to cities, villages, and townships on a straight per capita basis and these payments will be based on the federal census population counts for 2000. These payments and the distribution mechanism are defined in the Michigan constitution and continue unchanged.

Current Payments-Statutory

Payments totaling $939 million will be made to local units in FY2001 using statutorily-defined formulas, with $704 million going to cities, villages, and townships.

Combined Payments

The total amount each unit receives is based on five separate calculations and the resulting total payment may be modified if the year to year change in payments meets certain tests. The interaction between payments for all units affects the final amounts paid to each unit. As a consequence, the model used to estimate and project simultaneously calculates payments for nearly 1,800 units. The components are:

(1) Constitutional per capita payments

(2) Payment shares from FY1998 statutory formulas

(3) Unit type population weights

(4) Inverse per capita taxable value weights

(5) Yield equalization payments

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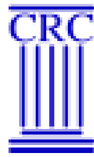

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Step 1—For a given year, the total amount to be distributed is based on the amount to be allocated by per capita payments plus the total amount determined by the four-part statutory portion (2) through (5). In FY2001, component (2) receives a 70 percent weight and components (3) through (5) a collective weight of 30 percent.

Step 2—For FY2001 and thereafter, two additional calculations are made. First, any unit whose population increased by ten percent or more from 1990 to 2000 receives the amount calculated in step 1. Any unit whose population change is less than a ten-percent increase is limited to an eight-percent increase in total per capita and statutory formula payments (1) through (5). Excess amounts are then distributed to units in the group in a way that a uniform floor in year to year percentage payment change is created at a level that exhausts the amounts in excess of the eight-percent increase. In FY2001 the minimum increase for units benefiting from this provision is 7.2 percent. The effects are dramatic for many units. A total of 116 units whose payments would decline receive an increase of 7.2 percent instead. Thirteen of these units would face year to year reductions exceeding ten percent.

Unresolved Issues

1) A relatively small number of units whose populations are projected to increase by more than ten percent will receive payment increases below the floor created for slower growing or declining units. This result was probably not intended and would be difficult to justify from the standpoint of equitable treatment of all units. In FY2001, 12 units fall into this category and by FY2006, 30 units are estimated to face this situation. Consideration should be given to modifying the legislation by making all units eligible to participate in eight-percent cap payments regardless of their 1990-2000 population change.

2) Elimination of units from contributing to the eight-percent cap mechanism if their population increase exceeds ten percent creates a notch effect that can result in very different payment growth for two similarly situated units. A small number of persons counted or not counted in the 2000 census can affect a unit's payments very significantly. The rationale for constraining payment growth for units with slower population growth even if the new formulas would result in large payment increases is not apparent. A comparable smoothing effect on payment changes could probably be achieved by eliminating the ten-percent threshold entirely and setting the maximum year-to-year payment increase at a higher level such as ten percent.

3) When the legislation sunsets June 30, 2006, several units will be at risk of sudden large payment declines. This will also be true if the ten-year phase in is allowed to run its course through the end of FY2008. Extending a payment growth cap mechanism or creating a separate pool of resources to protect against payment reductions should be considered.

4) Once Detroit has accomplished rate reduction for its city income tax, resumption of sharing in the growth of shared revenues should be considered.

As with any complicated piece of legislation, some fine-tuning is usually needed after a year or two of operation. Examination of the ten-percent cliff and the failure of the eight-percent cap mechanism to provide uniform protection against declining payments deserve attention soon. The other issues cited above should be resolved as plans are developed for revenue sharing after the sunset of the legislation.