



State and Local Revenues for Public Education in Michigan

Citizens Research Council of Michigan
Report 363
September 2010

This presentation is a summary of the full report, which
can be found at www.crcmich.org





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CRC's Education Project

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About This Report

- One in a series of reports on education governance and finance issues
- First on the topic of finances, followed by two more
- Resources examined at the aggregate (statewide) level, not district level
- Limited to operational funding, not capital funding
- Examine school funding in a larger context (economic, legal, and demographic factors), and how education funding fits into overall state budget



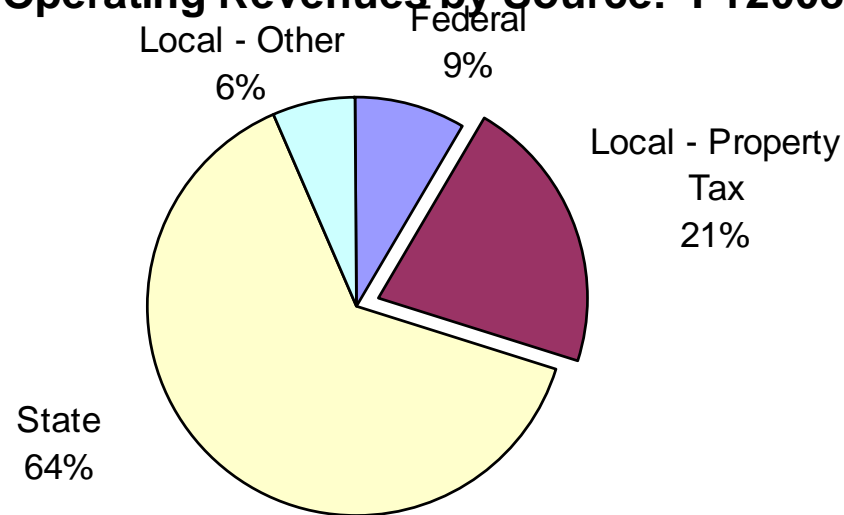
Michigan's State-Dominated School Finance System

- Despite substantial local property taxes supporting schools, total funding determined by state – Proposal A had direct and indirect centralization effects
- Majority role played by “state” taxes dedicated to the School Aid Fund
 - Increase in earmarked taxes and less discretionary funds
- Required “local” property taxes, with little option for supplementation
- Restrictions on tax base growth and caps on tax rates (Headlee and Proposal A), less so for ISDs
 - Growth in local tax base reduces state aid (foundation grant)
- State responsible for setting resource level, but local schools responsible for setting budget within resource constraints



State Effectively Controls 85% of School Operating Revenues

School Operating Revenues by Source: FY2008



Source: National Public Education Financial Survey



Two Major Things Going On

Both Related to Changes in the Economy

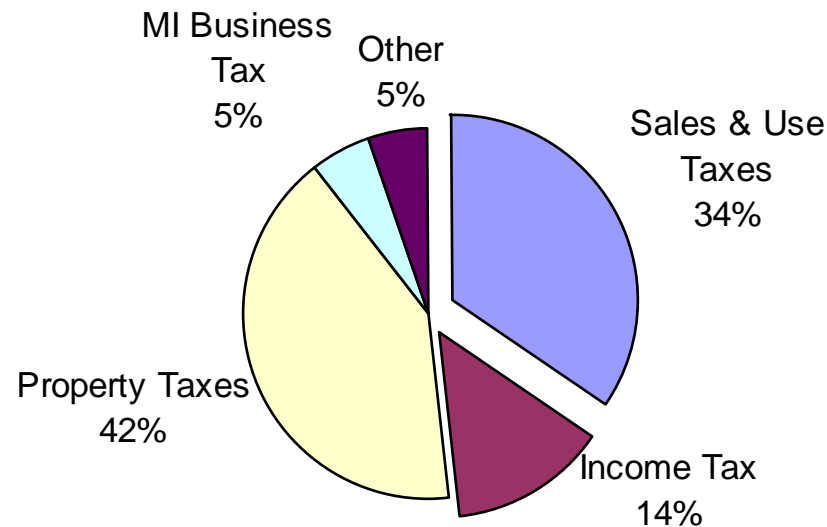
- Short-Term: Recent revenue performance clear product of Great Recession
 - Volatility of system demonstrated
 - Result in “re-setting” state revenue levels
 - Some stability provided by property tax and mix of taxes
- Longer-Term: Connection between economy and state revenues weakening
 - Evident in performance of major state taxes
- Third Factor: Over-lapping tax limitations related to property tax (Headlee and Proposal A)
 - Will constrain property tax growth (state and local) during rising property values – placing greater importance on state revenue growth in recovery



Economically Sensitive Taxes Dominate

Consumption and Income Taxes Make Up 48%

**State and Local Education Operating Taxes by Source
(FY2009 - \$14.0 billion*)**

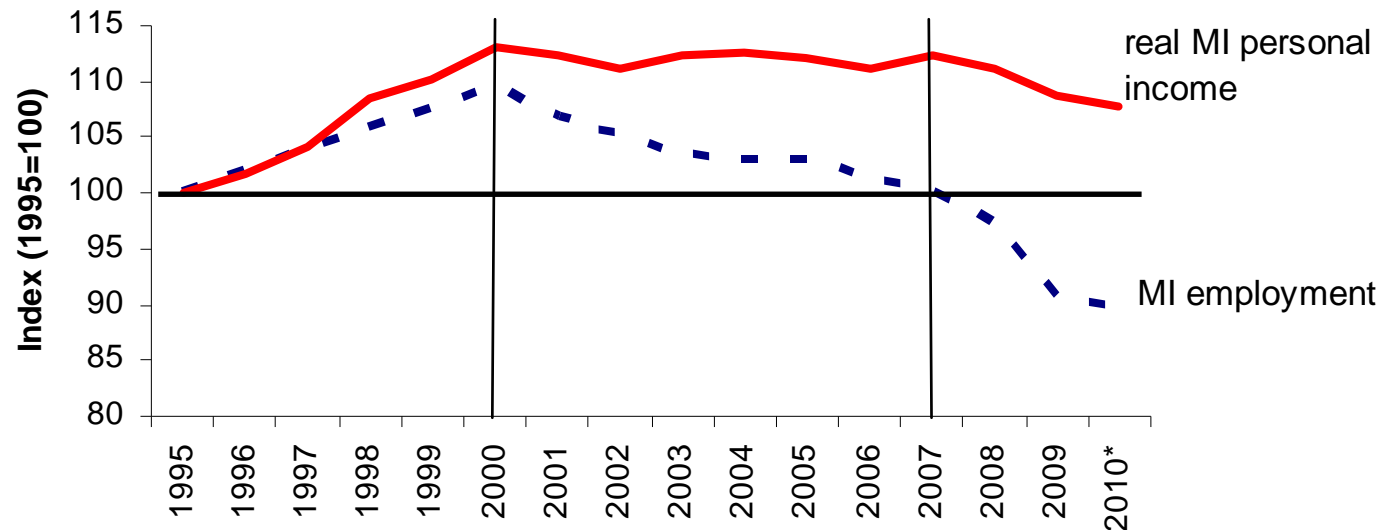


* Note: Michigan Dept. of Treasury; Michigan Dept. of Education; CRC



Three Distinct Periods of Economic Growth Since Proposal A

Michigan Employment and Real Personal Income Growth



Source: US Dept. of Commerce; US Dept. of Labor

*2010 based on May 2010 Consensus Revenue Estimates



"It was the best of times, it was the worst of times . . ." *State Revenue Performance Since Prop. A*

Annualized Growth Rates: FY1997 to FY2009

	FY1997 to	FY2001 to	FY2008 to
REVENUES	<u>FY2000</u>	<u>FY2008</u>	<u>FY2009</u>
State Taxes	6.2%	2.0%	-8.6%
Lottery Transfer	1.7%	3.4%	-2.2%
General Fund Transfer	4.6%	-31.6%	123.5%*
Total State-Source School Aid Fund	5.9%	1.5%	-7.8%
Michigan Personal Income	5.6%	2.2%	-3.0%
U.S. CPI	2.2%	2.8%	-0.3%

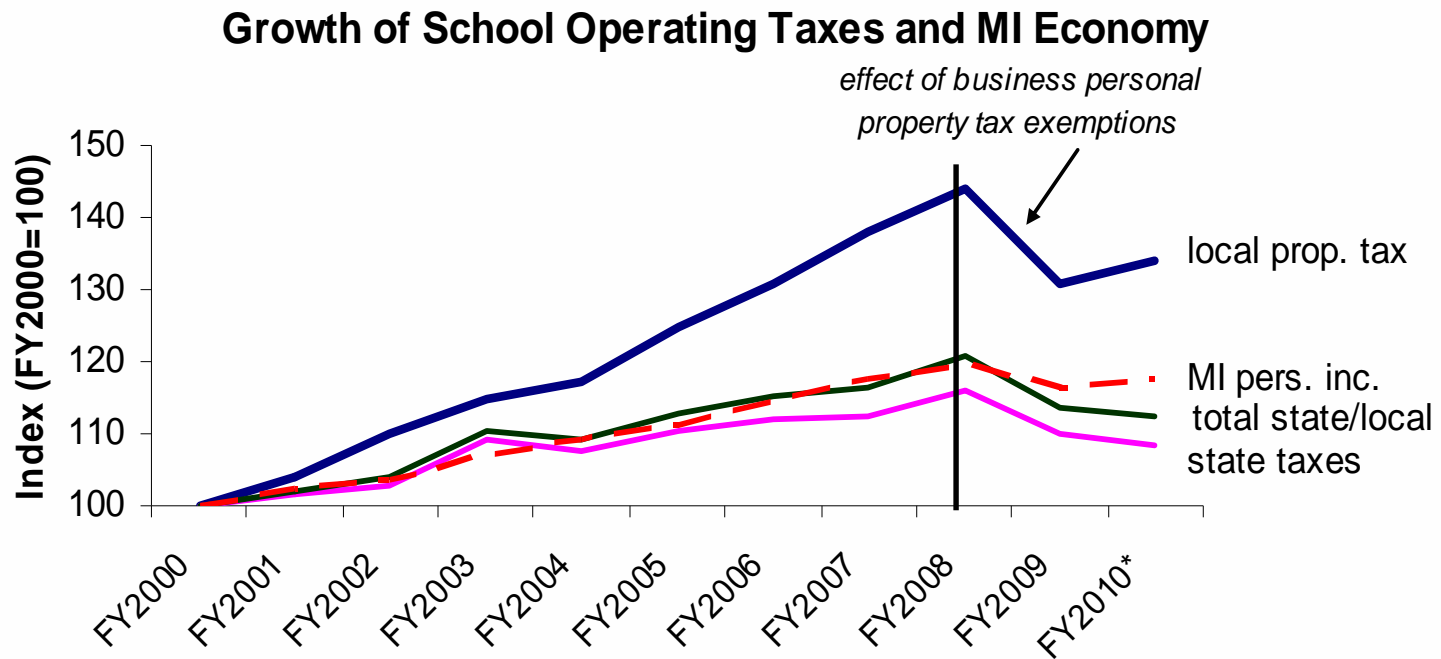
Source: Michigan Department of Education; U.S. Dept. of Commerce; U.S. Dept. of Labor; May 2010
Consensus Revenue Estimates adjusted for personal property tax exemptions

* Note: GF transfer increased from \$35 million to \$78 million



State Taxes Do Not Track Economy

Accelerated Decline Beginning in FY2008



Source: US Dept. of Commerce; Mich. Dept. of Education; Mich. Dept. of Treasury

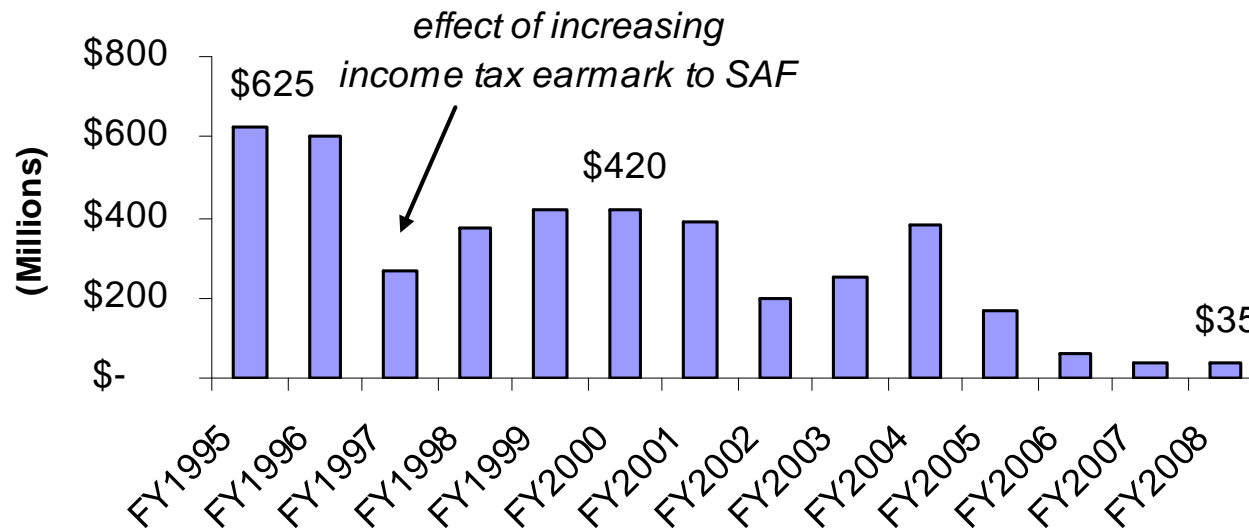
*FY2010 based on May 2010 Consensus Revenue Estimates



Spillover Effects

General Fund Budget Challenges Affect School Resources

General Fund Allocations to School Aid Fund



source: Michigan Dept. of Education



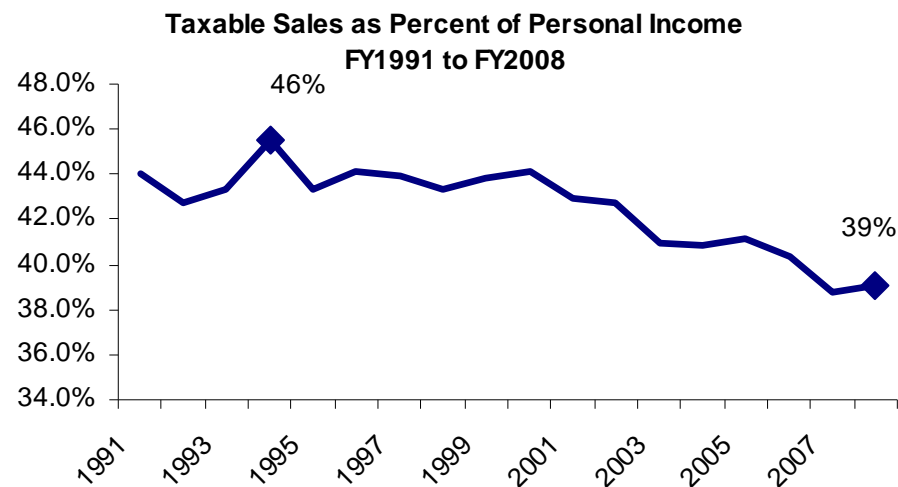
Why Long-Term Stability in Education Finances?

- Why is revenue stability important?
 - Demand for public goods and services relatively consistent
 - State and local governments are required to have balanced budget – predictability aids in this endeavor
- How to define “stability” – economic growth or costs?
- Linking education revenues to economic growth makes sense because:
 - Over long-run, as personal incomes grow, demand for public services grow
 - “Ability to pay” argument, otherwise need to look at more frequent tax rate increases
- Volatility will always be a concern, but can be addressed through
 - Tax composition – fairly balanced
 - Budgeting strategies – used in early 2000s



What are the Long-Term Stability Problems?

- **Sales Tax** – largest single source of funding for schools
 - Primarily on goods and few services
 - Services growing section of economy (healthcare) thus sales tax share of economy shrinking



Source: State of Michigan; US Dept of Commerce



What are the Long-Term Stability Problems?

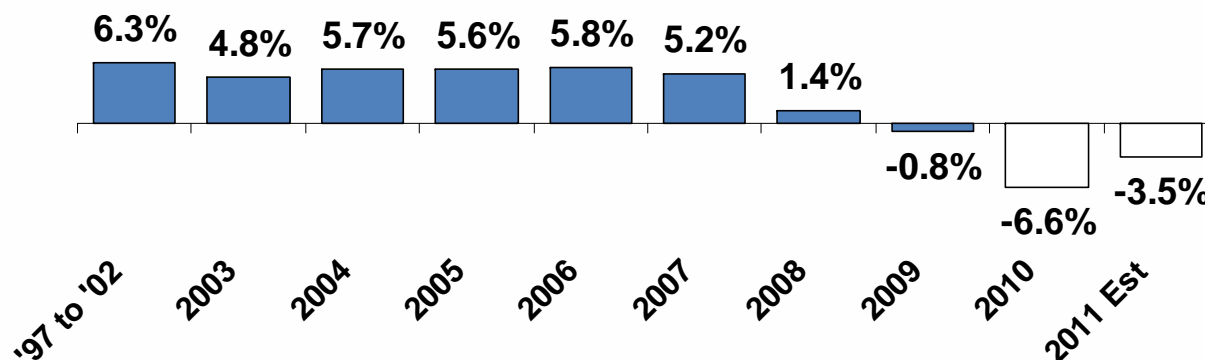
- **Income Tax** – structural, tax policy, and demographic issues
 - Structural: flat rate tax, less progressive than graduated rate structure, income growth at top
 - Tax Policy: schools protected from recent and future rate reductions (however did not benefit from increases)
 - Tax Policy/Demographic: “senior preferences”
 - very generous treatment of retirement income
 - property tax credit (GF impact only)



What are the Long-Term Stability Problems?

- **Property Taxes** – previously stable revenue source will decline with near-term erosion of taxable values
 - During recovery growth will be constrained by current tax limitations (capped at inflation if values escalate faster)
 - SET is second largest state source with income tax decline

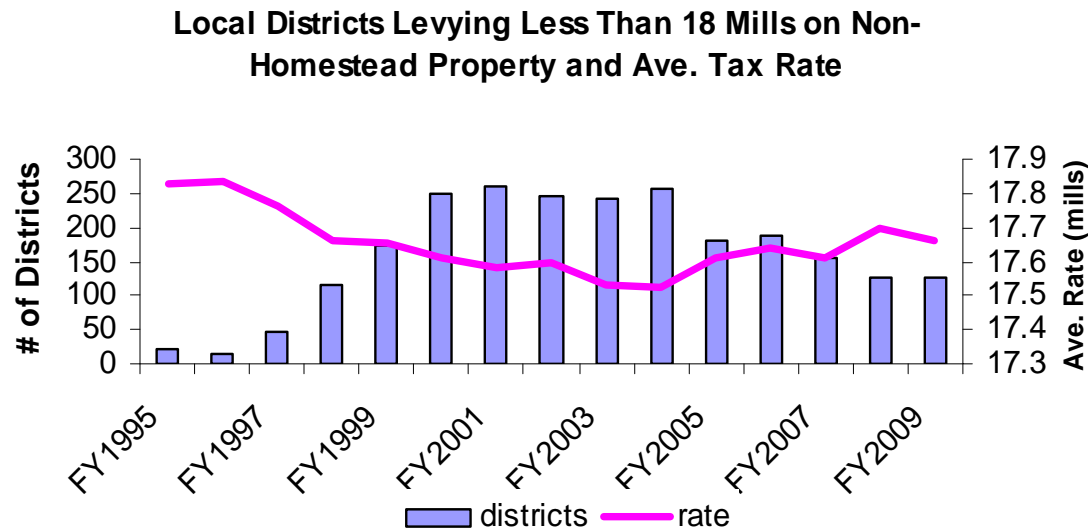
% Change in Total Taxable Value





What are the Long-Term Stability Problems?

- **Local** – Despite the “required” nature of 18-mill tax to receive state aid, “Headlee rollbacks” reduce local revenue
 - Headlee “override” votes are costly

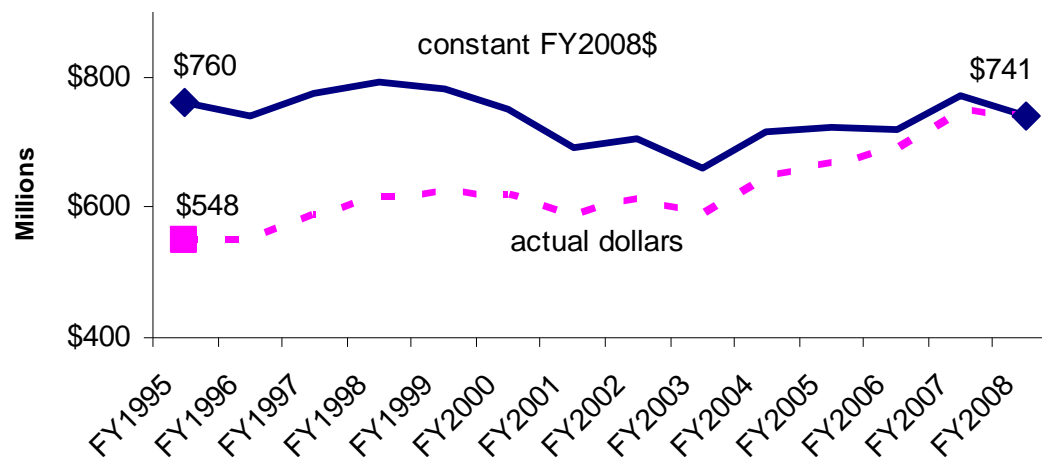




What are the Long-Term Stability Problems?

- **Lottery** – a minor source of state (6%) and even smaller portion of overall funding
 - Flat real growth due to competition for gaming dollars
 - Growth tied to introduction of new games, not economy
- **Tobacco** – long-term slide in consumption constrains revenues

Lottery Revenues Supporting Michigan Schools



source: Michigan Dept. of Education; U.S. Dept. of Commerce



Revenue Stability Issues Contribute to Long-Term Fiscal Imbalance

Projected Growth in Total Public Education Revenues and Spending: FY2008 to FY2017
(Dollars in Millions)

	Operating Revenues	Spending Pressures	Cumulative Deficit	Annual Increment
FY2008	\$17,729	\$17,729	\$0	
FY2009	18,095	18,444	(349)	(\$349)
FY2010	18,584	19,281	(697)	(\$348)
FY2011	19,153	20,152	(1,000)	(\$303)
FY2012	19,741	21,092	(1,351)	(\$351)
FY2013	20,349	22,083	(1,734)	(\$383)
FY2014	20,977	23,129	(2,152)	(\$418)
FY2015	21,627	24,234	(2,606)	(\$454)
FY2016	22,300	25,401	(3,101)	(\$495)
FY2017	22,995	26,636	(3,641)	(\$540)
Annualized Growth Rate	3.0%	4.7%		

Note: Original projections included in CRC Report 349, *Michigan's Fiscal Future*, 2008.



Enhancing Long-Term Stability

Basic Observations

- Recovery will determine the new “base”, but underlying relationships between MI economy and school revenues unaffected
- Repairing relationship will entail modernizing one or more of the major taxes
 - Does not imply “higher” taxes; however, there are policy issues and trade-offs
- Also, address local property tax limitations
 - Uncap growth limitations
 - Provide greater discretion in local-option revenues
- Can tax changes be paired with other policy objectives, e.g. greater equity, adequacy (Prop. A’s tax changes accomplished multiple policy objectives)



Enhancing Long-Term Stability

- **Expand Base of Sales Tax**
 - Align base of sales tax with economy by incorporating more services
 - Revenue-neutral shift through a lower rate
 - Substantial impact on tax base, but final growth rate will be determined by services selected
- Policy Issues and Trade-Offs
 - Equalize tax treatment of different consumption
 - Sales tax tends to be regressive
 - Reduce revenue volatility over business cycle



Enhancing Long-Term Stability

- **Increase Progressivity of Income Tax**
 - Modify rate structure to tax high-income tax payers at higher rates
 - Growth at upper end of income distribution
- **Expand Base of Income Tax**
 - Include income currently not taxed, including private pensions – expected to grow with “baby boomers”
- **Policy Issues and Trade-Offs**
 - Shift in tax burden to high-income tax payers and retirees
 - Increase revenue volatility over business cycle



Enhancing Long-Term Stability

- **Property Taxes (state and local)**
 - Redefine “growth” for purposes of Headlee to exclude “pop ups” that occur after transfer
 - Shift 18-mill tax to state-level tax (e.g., SET) to avoid future millage rate “roll backs”
 - Provide add’l options for local districts to seek millage increases, subject to state caps
- Policy Issues and Trade-Offs
 - Back-tracking on Proposal A
 - Provide more local control in education



Concluding Thoughts

- School finance system underwent major transformation in mid 1990s; however, the state tax structure is largely what existed 40 years ago
- As economy evolves, tax structure needs to evolve to provide stable revenues for schools
- The recent recession has “re-set” state revenue levels, but fundamental relationships remain
- Without revenue restructuring, delivery of services will have to be re-calibrated to match revenue stream that grows more slowly than economy



Thank You

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