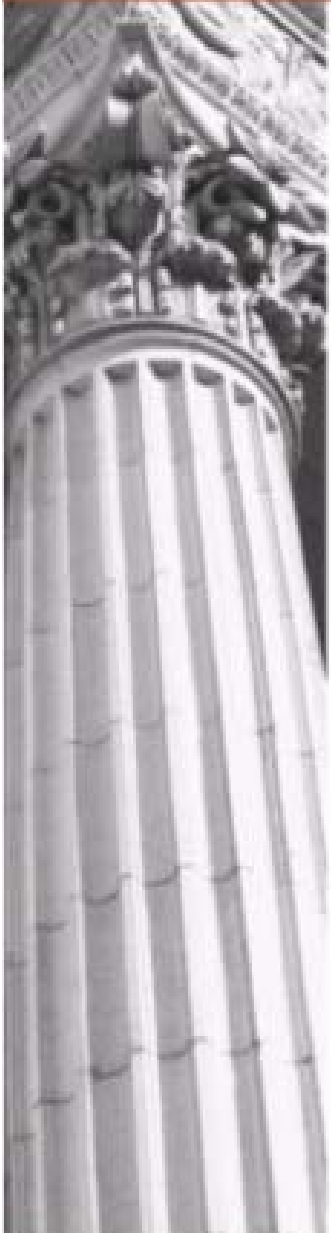




# Michigan K-12 Finances: Short- and Long-Term Challenges

League of Women Voters of the Midland Area  
February 12, 2011

Full reports and other materials can be found at  
[www.crcmich.org](http://www.crcmich.org)





## Citizens Research Council of Michigan

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- Relies on charitable contributions from Michigan foundations, businesses, organizations, and individuals



## Today's Agenda

- School Finance History: Proposal A
- School Revenue Performance Since Proposal A and School Finance Issues Today
- Long-Term Revenue Issues Facing Schools
- Policy Issues to Consider



## Today's Agenda

- **School Finance History: Proposal A**



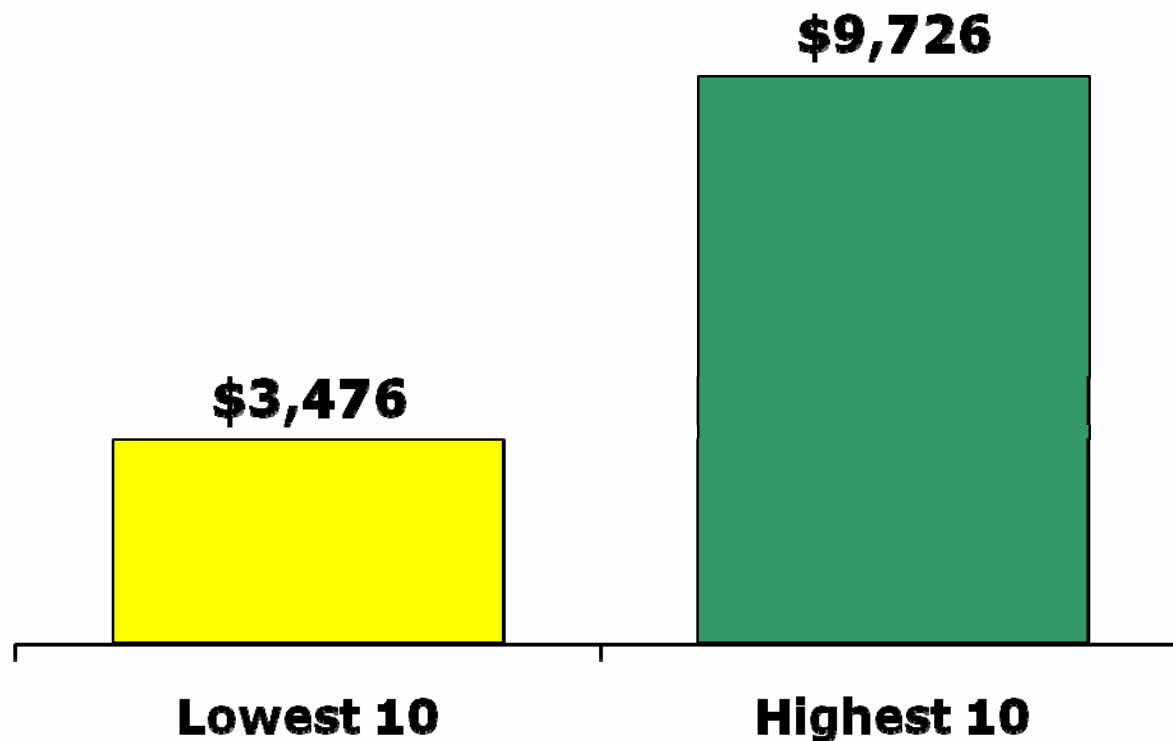
## **School Finances Before Reform**

### *Pre-Proposal A of 1994*

- 80 percent of K-12 revenue raised locally through property tax
  - Local voters choose spending level through property tax elections
  - School property taxes were rising faster than inflation and income resulting in pressure to reform
- “District power equalization” used for state aid, but richest one-third of districts received no aid
  - Rich districts greatly outspent poor districts, often with lower tax rates
- Kalakaska Schools close in March of 1993



## Rich Schools Out Spent Poor Schools More Than 3 to 1 In FY1994





## Proposal A -- Taxes

- Major state and local tax reform
- Local school operating tax repealed – ave 33.9 mills
- Replacement taxes:
  - Sales tax 4% to 6%
  - 6 mill statewide property tax
  - 18 mill non-homestead local tax
  - Cigarette tax from \$0.25 to \$0.75 (OTP 0% to 16%)
  - Real estate transfer tax 0.75% (new state tax)
- Taxable value cap imposed – limits per-parcel assessment growth to lesser of 5% or inflation



## Proposal A -- Spending

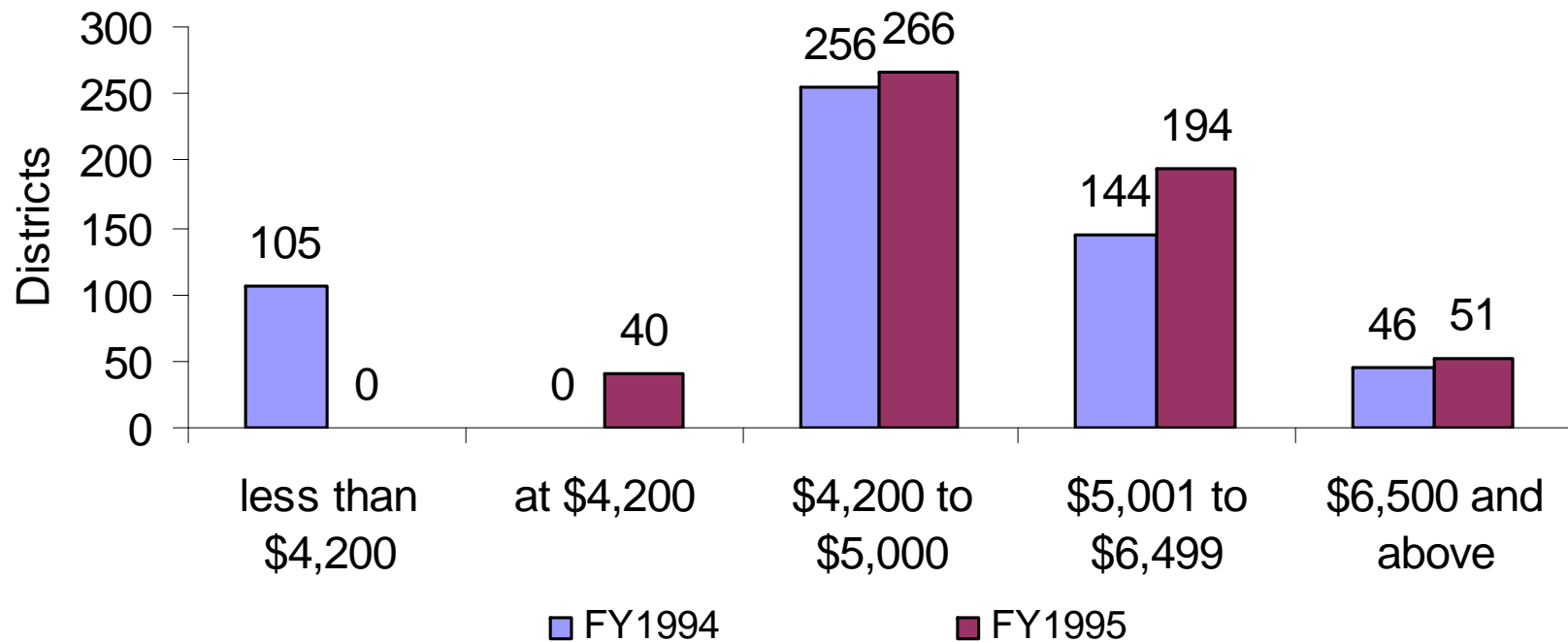
- Per-pupil spending set by state – “foundation grant”
  - Top spending schools allowed to keep old spending levels – some required to levy “hold harmless” millages
  - Bottom spending districts received larger per-pupil increases initially
- Local districts cannot choose to spend more than the amount set by the state
- No adjustment was made for district costs
- School choice enacted shortly after Proposal A





# Immediate Effects of "Raising the Bottom"

School Districts by Per-Pupil Funding Grouping





## Today's Agenda

- School Finance History: Proposal A
- **School Revenue Performance Since Proposal A and School Finance Issues Today**



# K-12 Education Finances Today

## *The Big Picture*

- Largest single outlay of combined state/local spending – \$17.2 B (2009)
- As result of Proposal A of 1994, we have a state-run state school finance system
- Revenues determined by Lansing, majority of spending decisions still set at local level (before Proposal A)
  - Very few options to raise add'l operating revenue locally, regardless of preferences
  - Spending concentrated in personnel (80% of total)
  - Required retirement spending set by state (9% of total)



## School Finance Issues Today

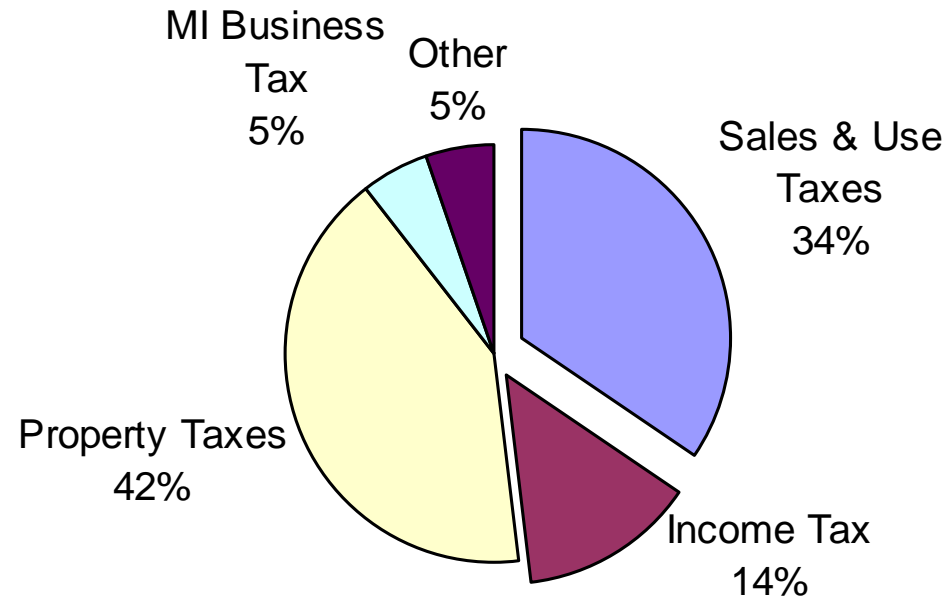
- Schools are dealing with several major issues, simultaneously
  - Since 2000, very little growth in overall resource level
  - Economic decline, especially 2009 drop, has lowered revenues below current expenditure base
  - Most districts facing declining enrollment, compounding the problem of slow revenue growth
  - Structure of major state taxes make it likely that revenues will grow slower than overall economy over the long run
  - Property tax limitations have been layered on top of one another that will constrain property tax growth going during recovery



# Economically Sensitive Taxes Dominate

*Consumption and Income Taxes Make Up 48%*

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

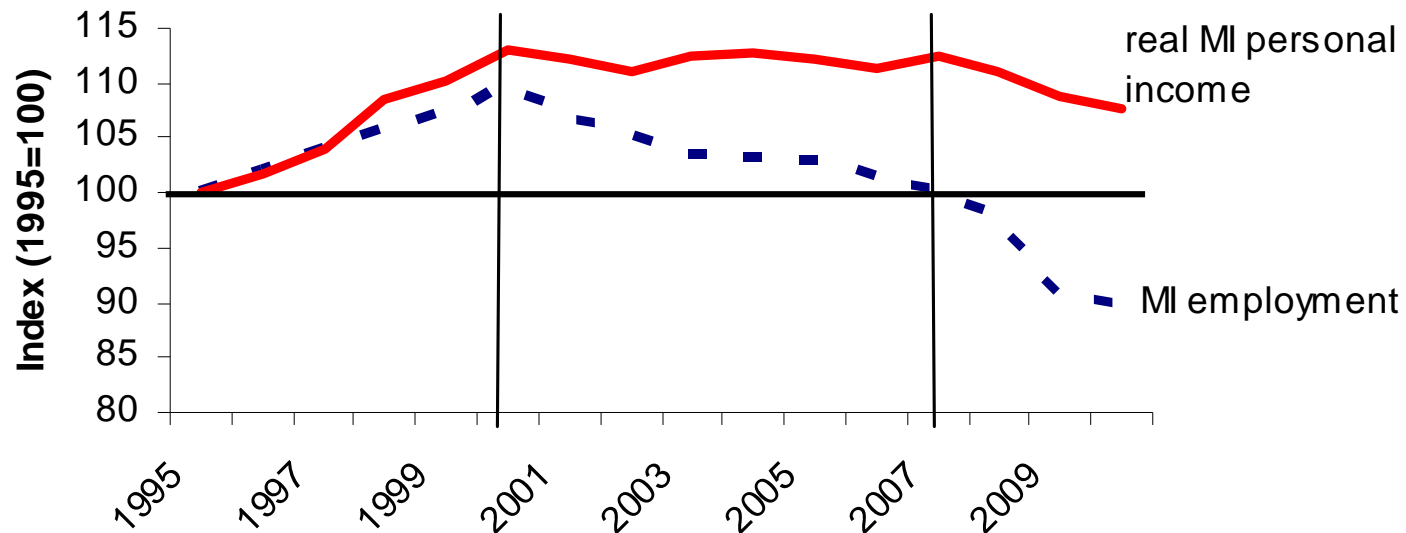


\* Note: Michigan Dept. of Treasury; Michigan Dept. of Education; CRC



## Three Distinct Periods of Economic Activity Since Proposal A

Michigan Employment and Real 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 FY2000	FY2001 to FY2008	FY2008 to FY2009
<b>REVENUES</b>			
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%
<b>Michigan Personal Income</b>	5.6%	2.2%	-3.0%
<b>U.S. CPI</b>	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

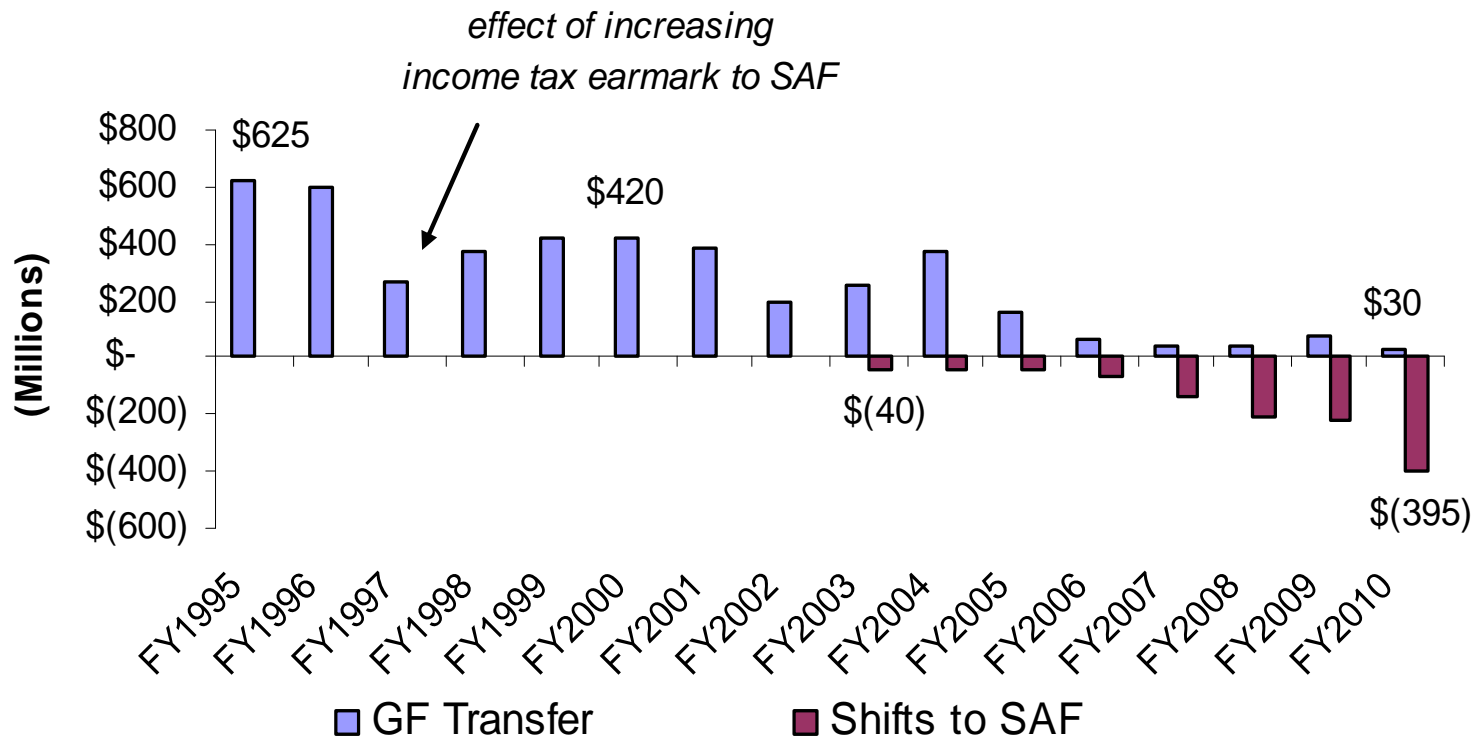
\* Note: GF transfer increased from \$35 million to \$78 million



# Spillover Effects

*General Fund Budget Challenges Affect School Resources*

## General Fund Transfers and Cost Shifts - School Aid Fund



16 \* FY2010 includes \$208 million for community college operations

Source: Michigan Department of Education; House Fiscal Agency





## Great Recession's Effects

*Steep Revenue Declines and Slow Recovery*

	annual growth rates			
	FY2009	FY2010	FY2011	FY2012
Sales	-10.1%	1.4%	2.9%	2.9%
Income	-19.0%	-5.5%	3.8%	0.4%
Use	-19.2%	9.3%	3.6%	4.3%
State Education	-1.9%	-5.4%	-3.7%	-1.3%
Real Estate Transfer	-26.2%	-3.0%	2.8%	8.8%
School Aid Fund	-5.1%	-1.0%	1.5%	2.0%
General Fund	-21.3%	-7.9%	6.5%	0.9%

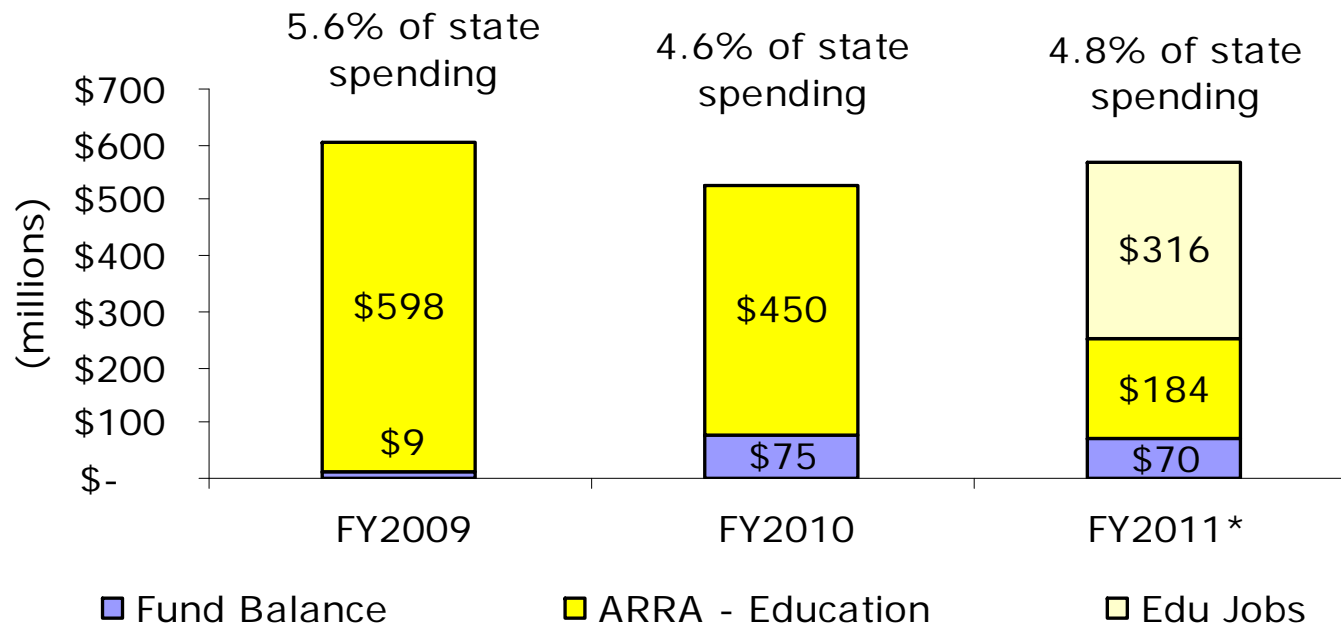
*FY2010 SAF down \$700 million from FY2008*



# Federal Funds Help Mitigate Cuts

## *Schools Face Revenue "Cliff" in FY2012*

Non-Recurring Resources Used for SAF Budget



Fund Balance = \$247 million at 10/1/08. State spending excludes federal.

\* Based on enacted budget as of 7/10 and projected Edu Jobs funding.



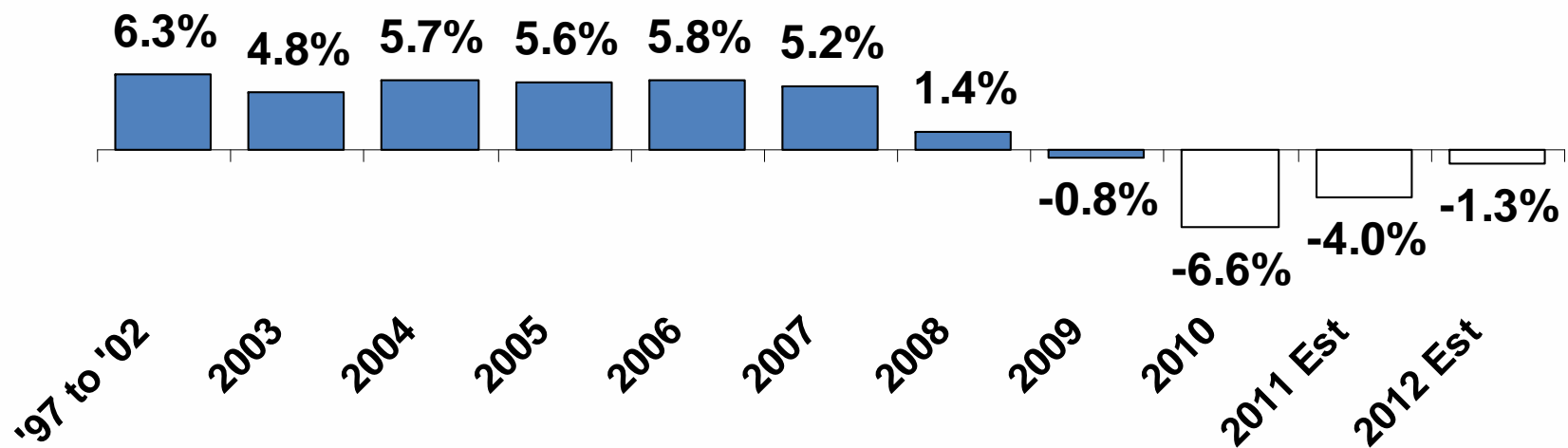
## **State Revenues Make the Turn, but Local Revenues Fall**

- To date, local property tax has provided stability to K-12 revenue picture – 5%/yr ('00 – '07) and flat in '08 and '09
  - Going forward this picture changes dramatically
  - TV falls in 2010, 2011, and 2012
  - State revenues not positioned to help
- Coming out of the downturn, tax value growth capped (Prop. A) – restrains revenue growth



## TV More Stable Due to Cap - Decline With Housing Crash

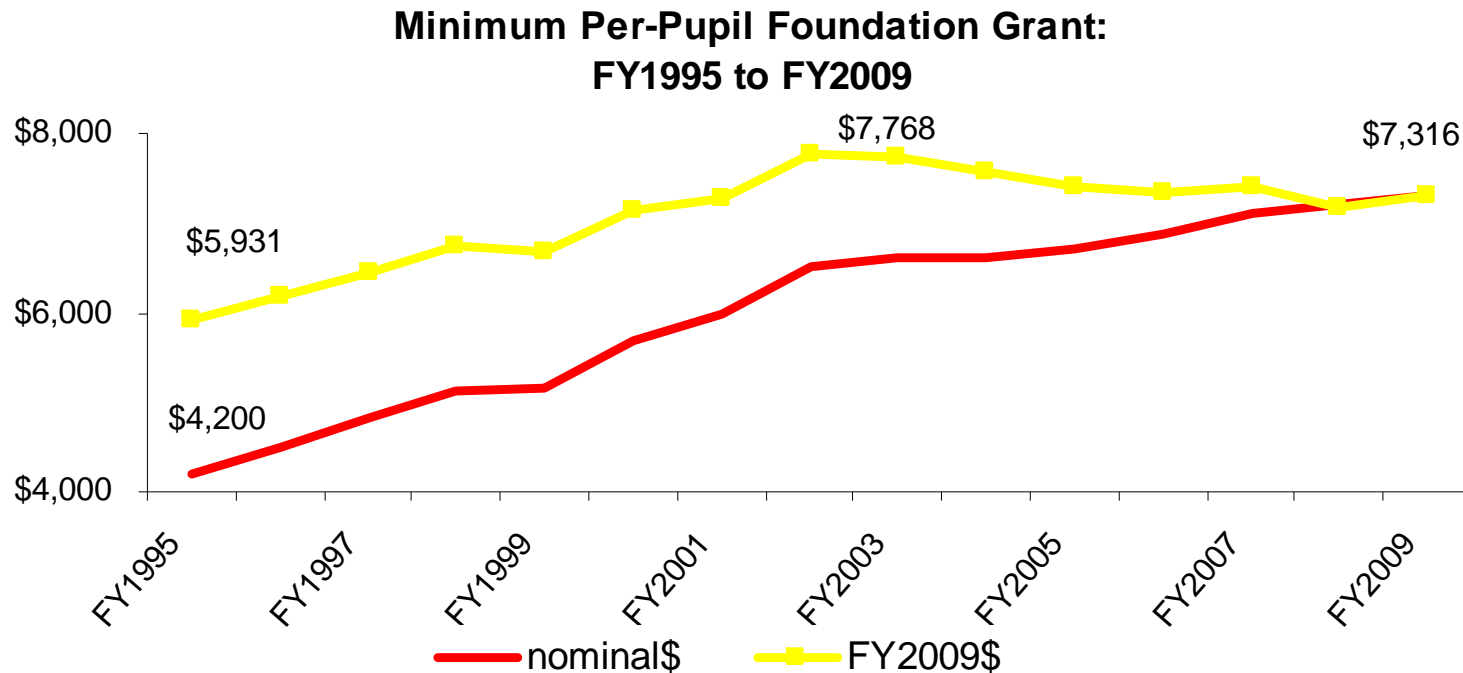
% Change in Total Taxable Value



Source: State Tax Commission and Michigan Department of Treasury Estimates.



## For Those at the Bottom Before A *Growth Exceeded Inflation*

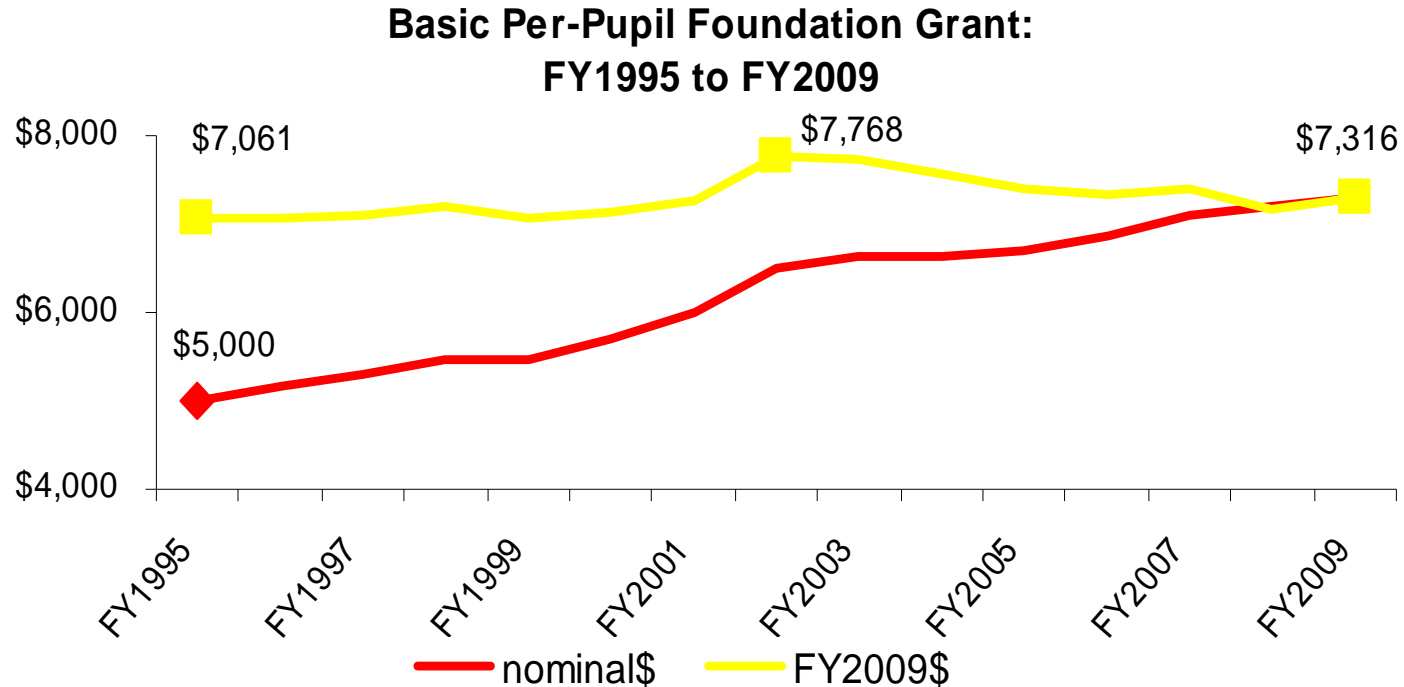


\* Min. grant adjusted using U.S. Consumer Price Index (state fiscal year basis).

Source: Senate Fiscal Agency; US Bureau of Labor Statistics



# Basic Grant Kept Pace with Inflation

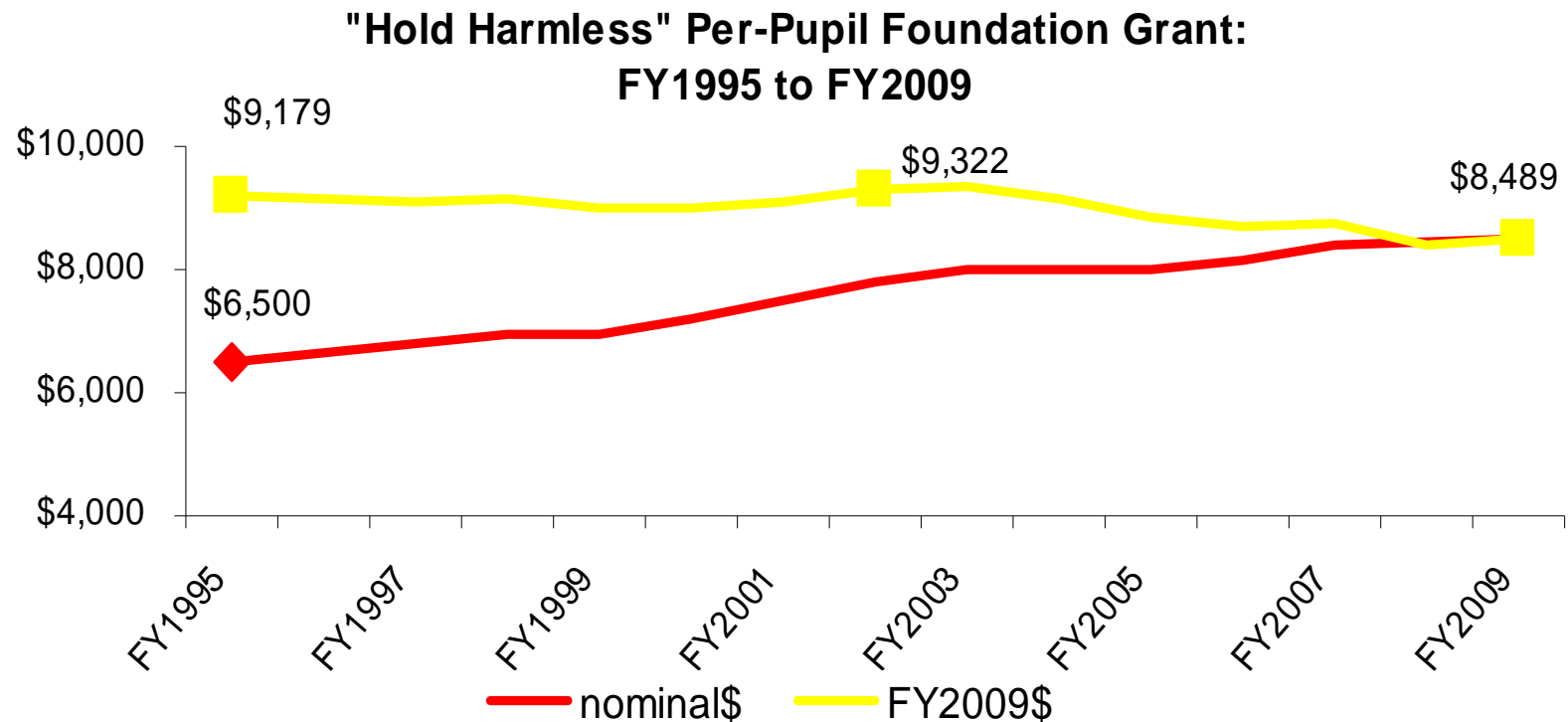


\* Basic grant adjusted using U.S. Consumer Price Index (state fiscal year basis).

Source: Senate Fiscal Agency; US Bureau of Labor Statistics



## For Those at the Top Before A *Inflation-Adjusted Grant Declined*



\* Grant adjusted using U.S. Consumer Price Index (state fiscal year basis).

Source: Senate Fiscal Agency; US Bureau of Labor Statistics



## Growth Also Depends on Period of Interest

*For 60% of Students No Real Growth Since FY2000*

Average Foundation Allowances of K-12 Students by FY1994 Quintile* FY1994, FY2000, and FY2009 (in 2009\$)						
Quintile**	FY1994	FY2000	FY2009	Change FY1994 - FY2000	Change FY2000 - FY2009	Change FY1994 – FY2009
1	\$6,065	\$7,135	\$7,322	\$1,070	\$187	\$1,257
2	\$6,760	\$7,152	\$7,325	\$391	\$173	\$564
3	\$7,452	\$7,570	\$7,498	\$119	(\$73)	\$46
4	\$7,964	\$7,997	\$7,816	\$33	(\$181)	(\$147)
5	\$10,319	\$9,981	\$9,255	(\$338)	(\$726)	(\$1,064)
Diff. = Q5 - Q1	\$4,254	\$2,846	\$1,933			
<p>* Foundation allowances include the supplemental allocation provided to eligible districts under Section 20j of the School Aid Act.</p> <p>** Quintiles based on FY2009 enrollments and each includes 302,600 students (5<sup>th</sup> quintile excludes two districts – Bois Blanc and Grant Twp – with small enrollments and high per-pupil revenues in FY1994).</p> <p>Source: Senate Fiscal Agency; U.S. Bureau of Labor Statistics, Consumer Price Index (state fiscal year basis); CRC calculations.</p>						





## Growth in Grant Important, but Enrollment Changes More So

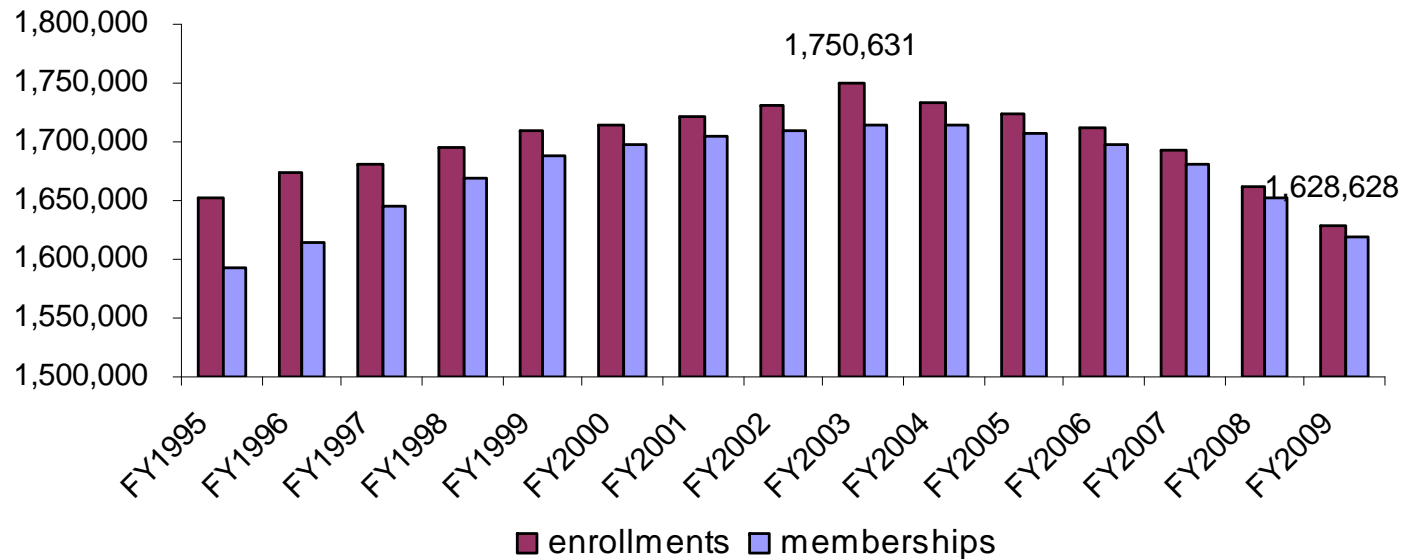
- Since FY2003- “Era of Declining Enrollments”
- Majority of districts and students affected
- More than one-half of districts below level they were at when Prop. A took effect
- Affects total foundation revenue, more so than growth in grant itself
  - Challenge of “managing down”
- Causes: loss of population (birth rates and migration), demographics, competition
- State response has been ineffective



# Two Periods of Enrollment Change

*Since FY2003 "Era of Declining Enrollments"*

Statewide Enrollments and Foundation Pupil Memberships



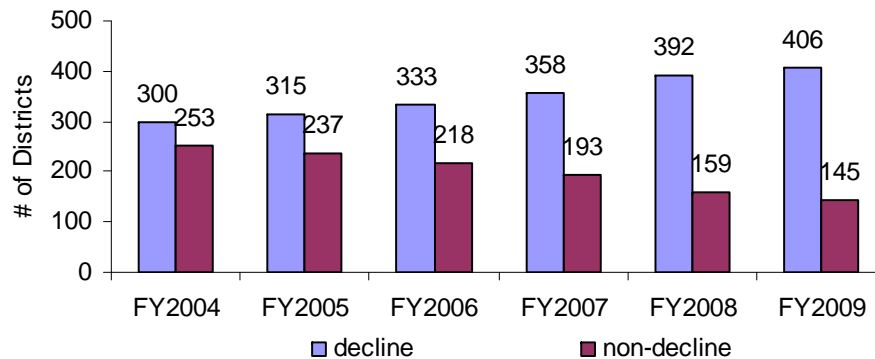
source: Michigan Department of Education, Bulletin 1014 and Financial Status Reports



# Two Very Different Experiences

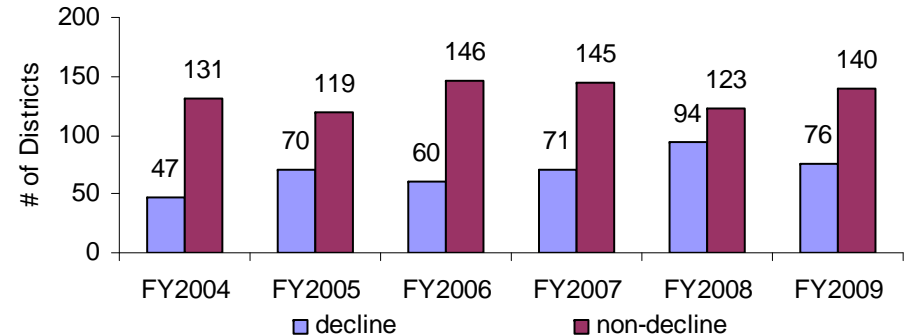
## *3 of 4 Traditional Districts See Loss in FY2009*

**Traditional Public Districts Enrollment Changes:  
FY2004 to FY2009**



source: Center for Educational Performance and Information

**Charter Schools Enrollment Changes:  
FY2004 to FY2009**



source: Center for Educational Performance and Information



# Total Foundation Funding Changes

*50% of Districts Received Less Foundation Funding in FY2009*

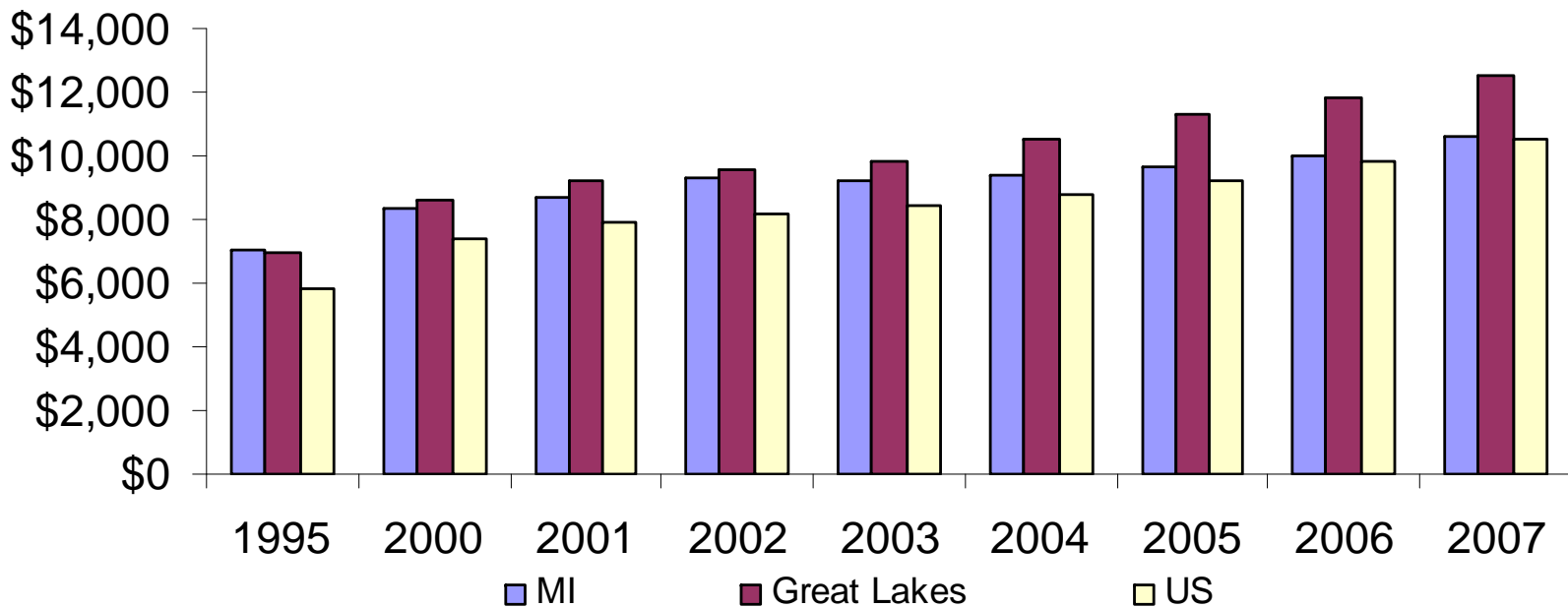
<b>Changes in Enrollment, Per-Pupil Grant, and Total Revenue by District Type: FY1995 to FY2009</b>						
	<b>Enrollment</b>		<b>Real Per-Pupil Grant (FY2009\$)</b>		<b>Total Foundation Revenue (FY2009\$)</b>	
	Decline	Non-Decline	Decline	Non-Decline	Decline	Non-Decline
City	18	8	19	7	18	8
Suburban	47	102	93	56	56	93
Rural	269	107	80	296	199	177
Total	334	217	192	359	273	278

Source: Center for Educational Performance and Information; Senate Fiscal Agency; U.S. Bureau of Labor Statistics, Consumer Price Index (state fiscal year basis); CRC calculations.



# Michigan's Advantage Slipped Considerably Since Prop. A

Total State and Local K-12 Revenue Per Pupil:  
Michigan, Great Lakes States, and US



source: US Census of Governments, School Systems



## Today's Agenda

- School Finance History: Proposal A
- School Revenue Performance Since Proposal A and School Finance Issues Today
- **Long-Term Revenue Issues Facing Schools**



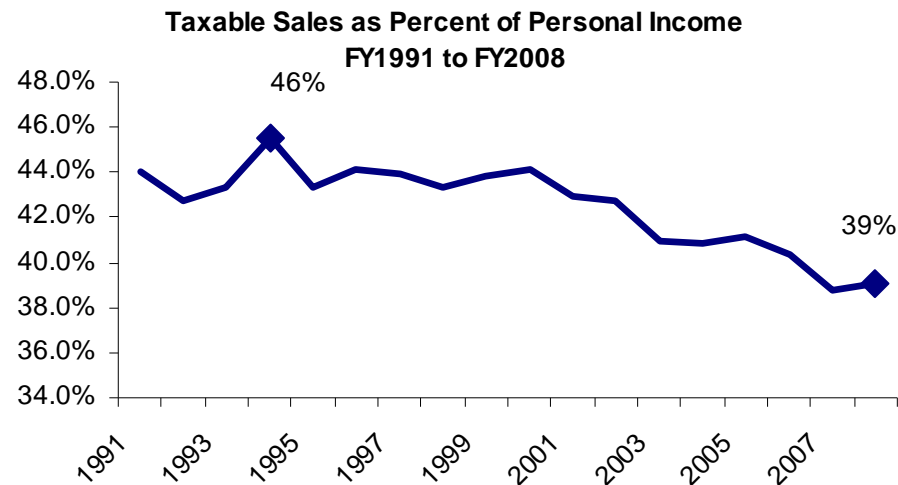
## Long-Term Stability Concerns

- 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
- Tradeoff: Volatility, but can be addressed through
  - Tax composition – fairly balanced
  - Budgeting strategies – used in early 2000s



## What are the Long-Term 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





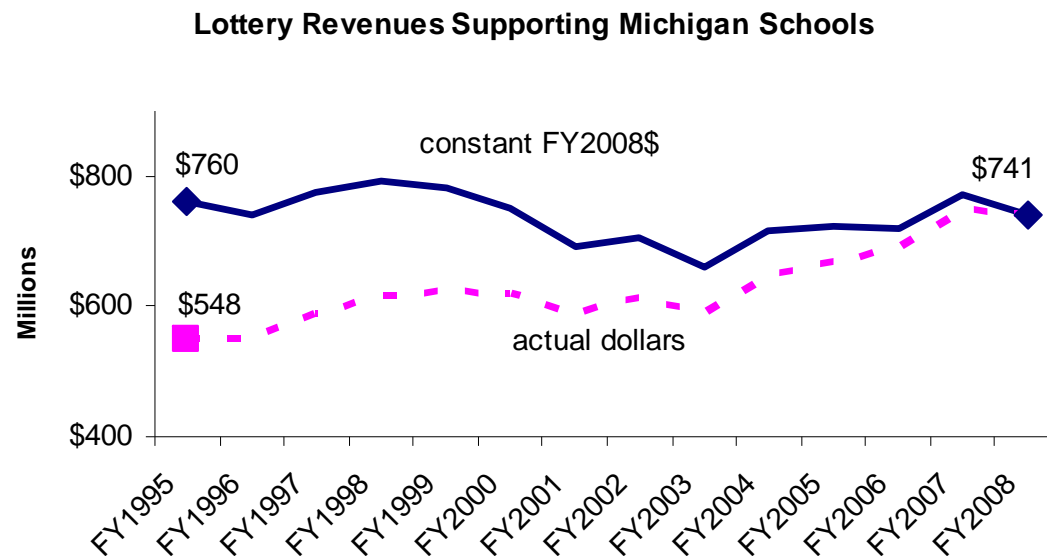
## What are the Long-Term Problems?

- **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 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



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 and perhaps dumping a minor tax
  - 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. service delivery, 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



## Contemplating Changes

- School finance system underwent major transformation in mid 1990s; however, the new system was based on a state tax structure that is largely the same one that existed 40 years ago
- As economy evolves, tax structure needs to evolve to provide stable revenues for schools and other public services
- The recent recession has “re-set” state revenue levels creating serious challenges in short-term, but fundamental relationships remain which portend long-term financial problems
- Without revenue restructuring, level and/or delivery of services will have to be re-calibrated to match revenue stream that grows more slowly than economy





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- School Finance History: Proposal A
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## School Finance Issues

- Tax structure
  - Are more revenues needed in short run?
  - Should structure be changed to increase chance that revenues will grow as fast as economy?
  - Provide more local options?
- Cost pressures
  - Should more be done to address retirement and health care costs?
  - End local control of expenditures?
- Should remaining spending gaps between districts be addressed?
  - Absolute “horizontal equity”?



## School Finance Issues

- Efficiency of service provision
  - Should districts be consolidated or more services shared?
  - Should consolidation/collaboration be imposed by the state or left up to local districts?
  - Should savings remain in local district or be assumed in state budget assumptions?
- School district costs
  - Should funding formula attempt to adjust for higher cost districts (e.g. at risk or cost of living)?



**Thank You**

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