CITIZENS RESEARCH COUNCIL OF MICHIGAN

"The right to criticize government is also an obligation to know what you're talking about."
Lent Upson, First Director of the Citizens Research Council

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Let's Reevaluate the Purpose of State Revenue Sharing as Part of Municipal Finance Reform

In a Nutshell

- Michigan's local governments primarily rely on property tax revenues and state revenue sharing payments to fund the public services they provide. However, an overreliance on property taxes is problematic, and state revenue sharing has historically been somewhat undependable.
- State lawmakers approved a welcome increase in state revenue sharing payments for the upcoming fiscal year. However, future years' revenue sharing commitments and their distribution between counties, cities, villages, and townships remain uncertain.
- It is time to take a step back to evaluate how Michigan's revenue sharing program fits into the broader local government fiscal landscape. A comprehensive review of how Michigan's local governments are funded would be a worthwhile task for the state legislature. Clarifying the state government's objectives for revenue sharing, aligning the funding levels and distribution formula with those goals, and potentially resetting the options for local governments to generate revenue would help local governments safeguard their future fiscal health.

Michigan's counties, cities, villages, and townships are breathing a sigh of relief with the passage of next year's state budget. In Fiscal Year 2025 (FY2025 runs October 2024-September 2025), revenue sharing payments – the sum of those obliged by the state constitution and those approved in the state budget – will increase overall by 11.5 percent over last year. With positive growth in state revenue sharing, and the anticipation that state legislators will establish a trust fund to earmark future revenue sharing resources, local governments have a cheerful outlook for the upcoming year.

With these latest commitments, one might conclude that the challenges facing local government finances are fading. Governments generally seek stable annual revenues that grow with an improving economy and increased financial support for additional public services. However, given the history of the inconsistent funding of the state's discretionary revenue sharing program, and the constraints on raising revenues at the local level, it is not yet time for local governments to claim the win.

As we, and others, have advised, a comprehensive look at the state's local government finance system is warranted if policymakers aim to improve local fiscal health in the future. Michigan's local governments deliver a range of government services with significant constitutional and statutory restrictions on how to fund them. Taking a step back and investigating feasible alternative systems for local government funding and state revenue sharing's role, will go far in changing this ongoing annual tussle between the state and its partner local governments.

State Revenue Sharing – Two Types of Funding

Michigan's bipartite local government revenue sharing program has two components, referred to as constitutional and statutory. We will be focusing on statutory revenue sharing, the component subject to annual legislative approval, here.

- **Constitutional Revenue Sharing**

Article IX, Section 10, of the Michigan Constitution earmarks 10 percent of total state sales tax revenues[1] to be shared with cities, villages, and townships on a per-capita basis. Michigan counties do not receive any constitutional revenue sharing payments.

- **Statutory Revenue Sharing**

Non-constitutional revenue sharing is subject to the annual state appropriations process. Currently, during each budget cycle, state policymakers determine the total amount of discretionary revenue sharing as well as its distribution. The components of the formula for distribution of these discretionary revenue sharing payments among cities, townships, villages, and also to counties, have changed over the years. For many years, the distribution formula was established in law. Some years, the allocation of payments was approved with the adopted budget. Between 1998 and 2007, both the total funding and distribution formula was provided for in appropriation bills.

Statutory Revenue Sharing Ups and Downs

Revenue sharing has been a part of Michigan's fiscal history since 1933. Over the decades, the program has expanded and changed. Initially, unrestricted payments were made to local governments to compensate for tax revenues lost when certain types of property were exempted from the tax base. During some years, payments were also contingent on fulfilling certain fiscal accountability tasks.

Changes over time to the allocation of the annual statutory revenue sharing appropriation among cities, villages, townships, and counties reflect the changing objectives for the revenue sharing program. This calculation of which local units get how much has become increasingly complicated. Starting in the early 1970s, population was weighted by tax effort to recognize the greater service responsibilities of densely-populated urban cities.

In the late 1990s, the allocation formula was changed to focus more on mitigating the fiscal disparity between jurisdictions, by addressing the relative tax yield and population density. In 1998, after almost two years of deliberation and study, the state legislature agreed upon the total allocation of state tax revenues for local governments, changed the source of funding, and adopted a new formula for distributing statutory revenue sharing payments. This revised program made Sales Tax revenues the sole source of revenue sharing funding (prior payments were from revenues raised by the Intangibles, Income, Single Business, and Sales taxes). The distribution of payments shifted and modified the dependence on tax effort. The legislature anticipated phasing in the components of the new formula over ten years. Implementation of this reform progressed for a few years and the legislature appropriated the full statutory amount of Sales Tax revenue to the program in FY2001.

By the early 2000s, the state's economy fell into a recession and cuts were made to statutory revenue sharing payments as the budget focused on other statewide priorities. In the end, the 1998 revisions were never fully implemented. Many local units of government ended up not receiving any statutory revenue sharing because of reductions in the overall program funding level, and the impact of the changing distribution formula.

In 2012, the revenue sharing program was rebranded as the Economic Vitality Incentive Program (EVIP), and redesigned. Local governments were encouraged to adopt best practices relating to fiscal accountability, transparency, consolidation/collaboration on service delivery, and pension reforms. This rebranding was short-lived as once again state budgetary pressures arose. Local units also had challenges in meeting the new good-government requirements.

After a few years, there was no interest in continuing the EVIP concept. The 1998 statute had expired in 2007, and the state's discretionary revenue sharing program was once again negotiated during annual state budget deliberations – for both the full program funding and how those funds were to be allocated amongst local governments. By 2021, with the onset of the pandemic, it seemed that the 1998 reforms were not ever going to be realized. However, in the most recent budget adopted, lawmakers committed more funding for revenue sharing (and publicly announced support for a trust fund) and reinstated a distribution formula very similar to the 1998 reforms.

For local government fiscal managers, the added uncertainty of how the state will distribute its statutory revenue sharing program dollars only exacerbates the ongoing unpredictability of the level of funding for the revenue sharing program overall.

Michigan's 2025 Revenue Sharing Program

In returning to a revenue sharing distribution formula similar to what was adopted in 1998, current lawmakers have implied those objectives of 26 years ago are still worth pursuing. The 1998 reforms had changed a fundamental premise of what had been part of the revenue sharing program since 1971—that state shared revenues would be distributed on relative tax effort.

There was some concern at the time that using relative tax effort would reward those local units with higher tax rates and encourage more public spending.[2] With a higher tax rate, a local government would not only raise more tax revenues to support local services, it would also benefit from a greater revenue sharing distribution from the state. The 1998 distribution formula changed the emphasis to addressing the fiscal disparities across local governments and accounting for the differences in public service delivery for different types of jurisdictions.

The components of the 1998 distribution formula included the following:

- **Unit Type**

One-third of payments were based on a population-weighting scheme that depended on the unit type – whether the local governmental unit was a city, township, village, or county, and its population size. The objective was to recognize that higher per-capita payments should be made to the more complex forms of government and the greater the population of the unit.

- **Inverse Taxable Value**

One-third of the payments were 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 was to provide greater state aid for local governments with less taxing capacity, as measured by TV per-capita.

- **Yield Equalization**

One-third of the payments were based on a calculation that made 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 was intended to provide greater state payments for local governments with lower taxing capacity and higher tax effort. Only units with TV per-capita below the state-defined minimum received allocations under this part of the formula.

Moving Forward

Given Michigan's tradition of home rule and taxation limits placed on local governments, revenue sharing will continue to be an ongoing and significant budgetary issue. The yearly debate reflects the doubt local governments have that state policymakers will honor the state's commitment to share revenues. From a local government's perspective, revenue sharing compensates for the revenue raising restrictions as well as for some public services they deliver to provide for the health and welfare of their residents. Adoption of the proposed revenue sharing trust fund is one way to ensure that funding for state revenue sharing payments is set aside, but as we have noted in other commentaries, earmarking is not necessarily the best long-term solution especially since, unless constitutionally established, legislators may amend the statute at their whim.

And it is only one part of the picture. Policymakers should view the state revenue sharing expenditure in context of the entire local government's fiscal structure. From a historical perspective it is clear the intent of the program has shifted. The goals of the program have changed from compensating to local governments for revenues lost due to state tax law changes, to an effort to equalize local tax yields, to a program that encouraged greater accountability and improved fiscal management, and back again.

Here are some areas to examine that would benefit from a comprehensive assessment of past performance and economic impacts of the state's revenue sharing program. By studying why these components of the local government finance system are not meeting the goals of local governments and policymakers, state and local decisionmakers can identify forward-looking policy solutions that will accomplish their overall objectives.

- **Reaffirming the state's objectives for revenue sharing payments to local governments**

Just over 50 percent of Michigan's state revenues are shared with local governments, school districts, and community colleges. This intergovernmental fiscal partnership demonstrates the dependence between state and local governments. What initially began as compensation for foregone tax revenue, the state revenue sharing program now supports several critical public services such as elections, county correction facilities, hospitals, and road maintenance. These are public services the residents of Michigan expect to be provided. State revenue sharing ensures that all areas of the state have access to those public services. State payments to local governments can also provide for a redistribution of resources to address varying tax capacity and density of demand. A first step to assessing the state's revenue sharing program will be to reaffirm the state's objectives, however broad they may be.

- **Distribution of State Revenue Sharing Payments**

With a clearer understanding of the goals by both local and state policymakers about what the modern objectives for revenue sharing, it will be easier to help land on an appropriate distribution schedule. Explicitly outlining the objectives and distribution formula in state statute rather than through budget implementation instructions would add clarity to revenue sharing policy objectives and provide greater certainty to local governments.

- **Local Option Taxes**

Current Michigan law restricts the taxes available to local governments to primarily the property tax, the income tax for cities, several minor taxes for counties, and some economic-development-related taxes. The restrictions on the types of taxes available, coupled with the limitations on tax rates (and growth of the property tax base), leave local governments few options for raising revenues. Exploring the potential of permitting local governments to levy local taxes would expand revenue options for many local governments. As this area is explored, it is important to consider the tax design and administration process to effectively evaluate the benefits and costs of levying new local taxes. Some local option taxes to consider include sales taxes, tourism taxes, or entertainment taxes.

- **Tax Limitations**

The contemporary landscape and long-term impact of constitutional and statutory tax limits should be evaluated. In addition, because tax limitations have been adopted at separate times and addressed different issues, the interaction of these limits may have resulted in unintended effects over the long term. Tax limitations, especially those voter-initiated, should not be dismissed, but an understanding of how these provisions have affected local government's fiscal management should be understood as potential policy solutions are explored.

The fiscal stability of local governments is an important public policy issue for state policymakers. With the significant reliance on state revenue sharing, and the upper bounds placed on property tax revenues, local governments have few alternatives to pursue to raise revenues to fund the services they provide at a level their residents want. The most recent budget allocation that increased state revenue sharing is an indication that state policymakers know that local government funding is a priority. A comprehensive review of how Michigan's local governments are funded would be a worthwhile task for the state legislature. Clarifying the objectives of revenue sharing, and perhaps resetting the options for local governments to generate revenue would help local governments safeguard their future fiscal health.

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[1] Article IX, Section 10 of the Michigan Constitution states that cities, villages, and townships will receive 15 percent of the state sales tax levied at four percent of the state sales tax; 100 percent of the additional two percent of the state sales tax levied is dedicated to the State School Aid Fund.

[2] Michigan's Fiscal and Economic Structure, State-Local Fiscal Relations: Counties, Cities, Villages and Townships, Wolfram, p. 389.

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Madhu held several leadership positions in state government and the non-profit sector prior to joining the Citizens Research Council in 2024. Her expertise is in local and state taxation, government finance, and regulatory policy. In addition to working on landmark tax, school finance, and pension reforms, she helped Michigan earn a AAA bond rating as Chief Deputy State Treasurer. Under her directorship of CEPI, Michigan became one of the first states to offer web-based performance metrics for school districts. Madhu also served as a Deputy Director at the Department of Environmental Quality and at the Michigan Agency for Energy. Her non-profit experience includes Director of Government Relations for the Michigan chapter of The Nature Conservancy, and Treasurer for a local ceramics cooperative.