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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Sustainable Funding For Local Governments

In a Nutshell

- The primary sources of revenue for Michigan's cities, villages, townships, and counties – property tax revenue and state revenue sharing payments – do not offer the growth and stability needed to address local governments' future fiscal needs.
- A proposal to dedicate future state sales tax revenues for state revenue sharing payments may assure local governments in the short-term, but such earmarks erode the efficacy of the state's annual budgetary process.
- To address sustainable funding for Michigan's local governments, state policymakers should consider expanding local government's revenue-raising alternatives by exploring local-option taxes.

During the 2023-24 legislative session, Michigan's local government representatives have been advocating to secure annual state discretionary funding for payments to counties, cities, townships, and villages in a new Revenue Sharing Trust Fund.

Cities, villages, and townships are guaranteed a portion of the state's annual sales tax revenue. And while not consistently, the state legislature has also granted local governments (counties included) additional revenue sharing funding through an appropriation in the annual state budget usually referred to as statutory state revenue sharing. While these discretionary payments[1] are not protected, there have been past efforts to shield these payments from annual cuts.

After struggling to stabilize finances and raise sufficient revenue to meet ongoing demands for local services, local governments are looking for ways to address their ongoing challenge for sustainable funding. Earmarking state sales tax revenues for all unrestricted state revenue sharing payments is one option, but there may be other revenue raising alternatives to explore at either the state or local level, such as local-option taxes. Evaluating these alternative approaches to sustainable funding for local governments is complex because of the interplay between Michigan's constitutional tax and revenue limitations. It is important to assess these options thoroughly as their impact on both state and local finances may not be so evident.

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[1] From 1971 until December 2002, discretionary revenue sharing payments were to be budgeted and distributed based on a statutory formula. However, that formula sunset in 2007. The distribution formula was updated in 1998. Its application was short-lived when across-the-board cuts to all local governments' payments were made during and after the 2002 recession. A new formula, referred to as the Economic Vitality Incentive Program, was put into place in FY 2012, but by FY 2015, this program too was abandoned. After FY 2015, the total funding and distribution for state revenue sharing payments continued to change to what it is today, an annual appropriation that includes a specific distribution schedule adopted in each year's state budget.

Constraints on Revenue Raising Options for Michigan's Local Governments

Property tax revenues and state revenue sharing payments are the primary sources of revenue for Michigan's local governments.[2] With state revenue sharing cuts over the past decade, local governments have had to rely even more heavily on property tax revenues to fund public services. However, given Michigan's constitutional and statutory limitations on tax levies, the tax rate, and the tax base, local governments have struggled to maintain sufficient operating balances to pay for the services they provide.

A levy limit restricts how much total tax revenue a government can collect annually. A tax rate limit restricts the millage rate that a government can levy. An assessment limit caps how much the value of property (the tax base) can rise from one year to the next. Michigan local governments face all three limitations. These limitations, coupled with the challenge of gaining voter approval for tax increases, leave local governments with few options to replace local revenue when faced when state revenue sharing payments are not what were anticipated.

State policymakers have historically considered the purpose of revenue sharing to both compensate local governments for revenues lost when local taxes were either repealed or preempted, and to also take advantage of efficiencies in administration and collection of taxes.

Local governments currently face both constitutional and statutory restrictions on local revenue options. Given this history, it seems that local governments' quandary, is to either continue to advocate for stable revenue sharing payments, request greater restricted state aid for services, or to reduce their costs of providing expected or required local services.

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[2] While local governments do have authorization to levy other excise taxes and a local income tax, here we focus solely on property taxes due to their overriding significance in local government revenues.

Local Governments Dependence on State Revenue Sharing

Revenue sharing has been a part of Michigan's fiscal history since 1933. 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 the past several decades, Michigan's revenue sharing program has also attempted to distribute payments by addressing the variable taxing capacities and service demands across the state's local governments.

Cities, villages, and townships annually receive 10 percent of the total state sales tax revenues[3] on a per-capita basis; Michigan counties do not receive any constitutional revenue sharing payments. In addition, through the annual budget process, counties, cities, villages, and townships receive statutory funding.

Discretionary state revenue sharing payments – statutory revenue sharing – have not been consistent over time due to fluctuating state revenues and other pressures on the state's annual budget. In addition, in some years, due to overall program funding variability, programmatic changes, and fiscal management requirements, some local units became ineligible for statutory state revenue sharing payments entirely.

In the budget adopted for Fiscal Year(FY) 2025, state revenue sharing payments will be increased 11.5 percent overall. A new three-factor distribution formula was adopted to address inequities in the tax base and service delivery burden across the state for a portion of the statutory payments.

Michigan's local governments' dependence on state revenue sharing payments may seem counterintuitive given the state's tradition of home rule. While local governments are authorized to levy certain excise taxes, property taxes, and income taxes, the constraints imposed on those taxes challenge the capacity of some local governments to raise sufficient revenue to fund the local services they provide. Economists have noted that "Michigan has a very centralized government structure for collecting revenue, but a very decentralized structure for providing services.[4]

Counties, cities, villages, and townships receive state payments for both specific programs and for general revenue support. State aid payments for court administration and road funding are governed by specific formulas and are restricted for those uses. General revenue sharing payments – both constitutional and statutory – are provided to local payments on an unrestricted basis. Local governments rely on these payments for general operations and local services. It is no surprise that local governments seek to ensure and stabilize state revenue sharing payments for the future, especially given the few options available to raise revenues locally for funding local services.

Proposed Revenue Sharing Trust Fund

A proposal currently advocated by the Michigan's local government associations would establish a new "Revenue Sharing Trust Fund" to receive dedicated revenues from the state sales tax in addition to those provided by the Michigan Constitution. Smarting from those years where anticipated annual state revenue sharing payments were either cut or reduced, local governments are seeking to earmark state sales tax revenues to fund ongoing annual revenue sharing payments at current or enhanced levels. By segregating additional sales tax revenues in a statutorily established trust fund, local governments hope to secure future funding levels for revenue sharing payments and preempt a future legislature from reducing those payments.

In 1998 and in years following, the Legislature adopted revenue sharing distribution formulae that simulated an earmark. However, the total overall line-item revenue sharing appropriation could still vary, resulting in each local government's payment being lower or higher than before. The current legislative proposals include establishing the trust fund, assigning state sales tax revenues, and offering a distribution schedule to counties, cities, villages, and townships. The assignment of tax revenue has its appeal, but such earmarks also carry some risk.

Policymakers have long struggled with the dilemma posed by earmarking state revenues. Linking a budgetary expenditure to a specific program can demonstrate the direct benefit of a particular tax or user fee. And by dedicating revenues for a specific purpose, earmarks can bring stability to program funding. On the other hand, earmarks erode legislators' effectiveness in the annual budgetary process and stymie the open deliberation of budgetary allocations during budget development. Finally, although improbable, in the case of discretionary revenue sharing, the act of earmarking a source of funding could discourage future fluctuations in payments based on political whims.

From a local government's perspective, a confirmed, unrestricted revenue sharing payment would aid long-term budgeting decisions. With a statutory earmark as proposed, a local government could see greater consistency in their state revenue sharing payment. A statutory earmark will ultimately not, however, prevent cuts to local funding in challenging economic times.

Michigan is one of few states that relies heavily on earmarks. In FY 2024, over 65 percent of Michigan's tax revenues were designated for specific expenditures. State sales tax revenues are already subject to significant earmarking, most notably for state school aid and constitutional revenue sharing payments.

Whether state earmarks for revenue sharing will address the actual on-going issue for Michigan local governments is unclear. Local government policymakers should consider long-term revenue-raising options alongside the trust fund proposal.

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[3] Michigan's 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.

[4] Michigan at the Millennium – A Benchmark and Analysis of Its Fiscal and Economic Structure – Fiscal

Relations Among the Federal Government, State Government, and Local Governments, in Michigan (Ronald C. Fisher and Jeffery P. Guilfoyle), p. 663.

Local-Option Taxes

Pursuing a dedicated trust fund to stabilize and secure future state revenues sharing payments is not an unreasonable strategy for Michigan's local governments. However, the drawbacks to earmarking state revenues from a state fiscal management perspective are significant. Local governments should consider some other options to expand their revenue raising options as well. Addressing the constitutional and statutory tax limitations to allow local governments to increase their property tax rates is one alternative. This would be a heavy political lift, however, especially with uncertain economic times ahead.

Another alternative is to diversify the revenue-raising choices available to local governments by authorizing a greater array of local-option taxes. We offered a detailed review of local-option taxes in the report, Diversifying Local-Source Revenue Options in Michigan. The report identifies what local-option taxes are currently available to local governments, such as a local city income tax and tourism-related taxes for cities and counties. While acknowledging the potential administrative burden and jurisdictional economic disparities that can occur with local-option taxes, the report recommends that with appropriate structuring of such tax policies, local-option taxes offer a desirable revenue-raising opportunity for local governments that captures local economic activity and gives agency to their own residents to determine the level of services they wish to receive. Locally-levied taxes would reduce a local government's reliance on property taxes and state revenue sharing. The menu of local-option taxes could include taxes on retail sales, accommodations, alcohol, transportation fuels, gaming, etc., for example. Each option should be evaluated to determine its efficacy and legal landscape as different taxes may be more appropriate than others in particular jurisdictions.

A Longer-term Resolution

The issues facing local governments are many and the challenge of securing a stable, predictable level of funding for the services they provide is not going away soon. We can assume that there will be ongoing pressure to maintain funding levels for local government given the state's existing emphasis on state revenue sharing and local property taxes as the major sources of revenue for local governments. And there is no certainty that a future legislature facing difficult choices in tough economic times will not dip into a dedicated fund such as a Revenue Sharing Trust Fund for pressing priorities. It has happened before.

As today's state legislators deliberate the advantages and disadvantages of a Revenue Sharing Trust Fund, they should also consider alternative sources of sustainable funding for local government. A dedicated trust fund will not resolve the long-standing dilemma of ensuring Michigan's local governments are adequately funded to provide the services expected. It is time we explored local-option taxes to diversify local government revenue-raising opportunities in the future.

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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.

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