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of Michigan

CRC

State and Local Revenues for Public Education in Michigan

September 2010

Report 363

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CITIZENS RESEARCH COUNCIL OF MICHIGAN

CRC

STATE AND LOCAL REVENUES FOR PUBLIC EDUCATION IN MICHIGAN

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REPORT 363

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Public K-12 Education in Michigan

Entering 2010, Michigan residents find public primary and secondary education facing numerous challenges:

- State revenues are falling;
- Local revenue growth is stagnating;
- K-12 education service providers are facing escalating cost pressures, with annual growth rates outpacing the projected growth in available resources;
- Spikes in the level of federal education funding resulting from the American Recovery and Reinvestment Act of 2009 (ARRA) will produce a budgetary "cliff" when the additional dollars expire; and
- School district organization and service provision structures are being reviewed with the goals of reducing costs and increasing efficiencies.

Because of the critical importance of education to the state, its economy, and its budget, the Citizens Research Council of Michigan (CRC) plans a long-term project researching education in Michigan with an emphasis on the current governance, funding, and service provision structures and their sustainability.

Because of the breadth of topics and issues touched upon in each of these areas, it was determined that, in some cases, it would be necessary to address each broad issue through multiple reports. Since the topic of education finance is so complex, we have divided the subject matter into three reports.

This report represents the first analysis that will be produced by CRC on school finances in Michigan. This first report focuses primarily on the state and local revenues available to support public education, with particular attention paid to the structure of the financing system and changes to it over time. This report also covers the major factors, economic, political, and demographic, that influence performance of state and local revenues. The discussion of federal funding is reserved for the second education finance report because state and local officials exercise very limited control over the amount and distribution of these funds.

The second report will concentrate on the distribution of state, local, and federal resources among local and intermediate school districts. Considerable attention will be directed at the per-pupil foundation allowance grant, which is responsible for allocating the vast majority of state and local resources among districts, and the key challenges facing this system. This report also will look at the methods and policies for targeting resources to specific subsets of schools and students throughout the state via categorical funding and the changes to this type of funding over time. Finally, the role of federal funding and the related programs will be covered in this report.

A third report will be an in-depth examination of school expenditures, including those growing spending pressures that contribute to fiscal distress at the local level. We will take a close look at the causes and implications of deficits in school districts and the state laws and processes that govern such occurrences.

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Citizens Research Council Education Project

In 2009, CRC was approached by a consortium of education interests and asked to take a comprehensive look at education in Michigan. CRC agreed to do this because of the importance of education to the prosperity of the state, historically and prospectively, and also because of the share of the state budget that education demands. Education is critical to the state and its citizens for many reasons: 1) A successful democracy relies on an educated citizenry. 2) Reeducating workers and preparing students for the global economy are both crucial to transforming Michigan's economy. 3) Education is vital to state and local budgets. 4) Public education represents a government program that many residents directly benefit from, not to mention the indirect benefits associated with living and working with educated people. As with all CRC research, findings and recommendations will flow from objective facts and analyses and will be made publicly available. Funding for this research effort is being provided by the education consortium and some Michigan foundations. CRC is still soliciting funds for this project from the business and foundation communities.

The goal of this comprehensive review of education is to provide the necessary data and expertise to inform the education debate in Lansing and around the state. This is a long-term project that will take much of the focus of CRC in 2010 and into 2011. While an overall project completion date is unknown, CRC plans to approach the project in stages and release reports as they are completed. Topic areas CRC plans to study include education governance, K-12 revenues and school finance, school district spending analyses, public school academies (PSAs) and non-traditional schools, school district service provision and reorganization, and analyses of changes to Michigan's educational system.

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Summary

Financial support for Michigan public elementary and secondary education continues to be a major public policy issue despite the fact that significant resources are dedicated to serving nearly 1.7 million children each year. In state Fiscal Year 2007-2008 (FY2008) Michigan schools received $16.2 billion in state and local revenues for on-going operations. This support equaled 4.6 percent of Michigan personal income in FY2008. Although public education is a priority, there are concerns that it is currently under-funded, and that spending pressures will outpace the resources available each year in the future.

Some of the current concerns about the financial support for education can be better understood in the context of the financing system and its components. Specifically focusing on the financing system's design and the economic, political, and demographic factors affecting it provides valuable insights into the outputs it generates, such as the level of resources in the aggregate or on a per-pupil basis. The structure of the system and its components influences how resources grow year-over-year. Michigan's education financing system is influenced by a variety of factors, most notably the underlying economic bases upon which public revenues (primarily taxes) are derived, demographic changes involving the aging of the Michigan populace, and modifications to state law, specifically tax policy changes. Furthermore, because financing public education is a state responsibility as a result of Proposal A of 1994, these finances have to be understood in the larger context of aggregate state finances.

Most of the recent discussion on the issue of school finance and recommendations for reform focus on the amount of state financial support for education. Central to this discussion is the slowdown in state School Aid Fund revenue growth arising from the transformation of Michigan's economy dating back to the beginning of the last decade. Compounding the effects of the structural changes in the economy was the failure of the Michigan economy to exhibit any sustained rebound from the mild 2000-2001 recession. These factors combined to negatively affect the state's ability to increase support for education throughout much of the last decade, especially in relation to economic activity and prices. Recently, the Great Recession of 2008 decimated state tax revenues from all sources, causing actual year-over-year declines in FY2009 and FY2010. The revenue picture facing Michigan schools beginning in the early 2000s is much different than that immediately following the Proposal A reforms, when the state's economic picture was much brighter.

Looking forward and absent state policy changes, state support for education will be contingent on Michigan's recovery from the Great Recession. Both the strength and duration of a recovery will be factors in determining the level of state resources in the near term. However, future state revenues, regardless of their ultimate level, will face new demands arising from the decline in property values that will drive down property taxes dedicated to schools. Property taxes exhibited considerable stability since the adoption of Proposal A. Any growth in state tax revenues dedicated to schools is likely to be negatively affected by the loss of local revenues, thereby continuing the fiscal pressures of the past into the foreseeable future. Prospectively, and over the longer-term, annual growth potential of education revenues will be contingent on the structural relationships between the tax bases and economic activity in the state. It is expected that demographic, legal, and economic factors will combine to further weaken the relationships in the future. Given the extremely centralized nature of the financing system, only state, and not local, policy makers have the authority to address these weaknesses.

Michigan's Education Revenue Structure: State-Dominated Financing System

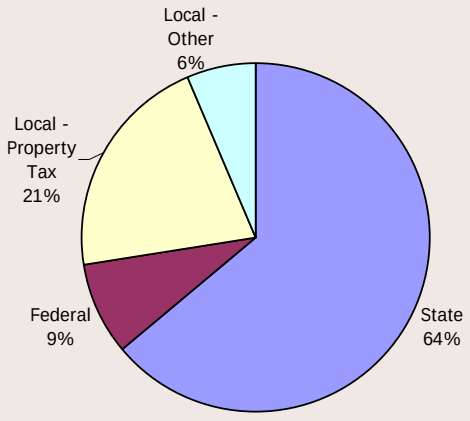
The school finance reforms of the mid-1990s ushered in a completely new method for financing public education in Michigan. The most visible and most significant fiscal effect of the school finance reforms was the shift in primary responsibility for funding education. The reforms centralized education revenue-raising responsibility at the state level, accompanied by an increase in level of earmarked revenues for education.

Centralization had both "direct" and "indirect" aspects. In a direct sense, existing state taxes were increased and new taxes authorized. Revenues from these state tax changes were designed to replace the resources generated by local property taxes following substantial rate reductions. Furthermore, the new system strictly limited "local-option" revenue supplementation. In terms of indirect effects, the reforms created stringent caps on local property tax rates and tax base growth such that the "local" revenues generated by the system are effectively "state" revenues. Taken together, the various aspects of centralization resulted in a school finance system that is entirely state-run in terms of annual operating revenues for schools. Given the practical realities of the current financing system, state-controlled revenues (directly or indirectly) comprise nearly 85 percent of the total operating funding for local schools (**Chart A)**. As a result, state, not local, policy makers control the purse strings of Michigan's local schools.

Proposal A created a real mismatch in terms of crafting annual budgets at the school district level, something that did not exist before Proposal A. State officials effectively control the purse strings, but local school boards and administrators are responsible for setting the spending priorities. During times of expanding budgets, this may not be viewed as problematic; however, in austere times, the fiscal arrangement proves more difficult for achieving required budget balance.

School finance centralization helped achieve specific, long-standing tax policy objectives. Specifically, the tax landscape in the state changed on a number of fronts: 1) property tax burden fell to below the U.S. average; 2) the consumption tax burden increased relative to the national average; and 3) the overall composition of major taxes (property, consumption, and income) became more balanced and more closely mirrored the U.S. average.

Chart A
School Operating Revenues by Source: FY2008



Source: National Public Education Financial Survey

Economic Performance Key Factor

Centralization directly linked education finances to the performance of the Michigan economy, both in terms of the dedicated state taxes (consumption and income) as well as the discretionary resources (General Fund allocation) available to schools each year. Since the adoption of Proposal A, Michigan went from being a state in the top one-third in terms of individual wealth in 1995 to one that is in the bottom fourth of all states today. This significant economic slide has had profound effects on education funding, as well as the finances of other public services.

Economic performance over the past 15 years (1995 through 2009) should be divided into three distinct subperiods and school finances examined accordingly. The first period (1995 through 2000) was characterized by steady and stable economic growth, measured in terms of employment level and the amount of income earned. In contrast, during the second period (2001 through 2008), employment levels declined and annual personal income growth slowed in nominal terms and in some years declined in real terms. Although Michigan was affected by the mild 2001 recession during this period, the fundamental economic problem which directly influenced public education finances centered on the complete transformation of the economic base, led by the auto sector.

The third and most recent period (2009 to present) is marked by a continuation of the job losses and income declines of the previous period, but at an accelerated rate because of the severe national recession that took hold in 2008. The recessionary effects of today have been compounded by the fact that Michigan's economy continues to undergo the final stages of a massive "rebalancing", with a concentrated shift away from its traditional manufacturing base.

Table A
School Aid Fund Revenue Annualized Growth Rates: FY1997 to FY2009

Revenues	FY1997 to FY2000	FY2001 to FY2008	FY1997 to FY2008	FY2008 to FY2009
State Taxes	6.2%	2.0%	3.1%	-8.6%
Lottery Transfer	1.7%	3.4%	2.1%	-2.2%
General Fund Transfer	4.6%	-31.6%	-18.5%	123.5%
Total State-Source School Aid Fund	5.9%	1.5%	2.7%	-7.8%
Michigan Personal Income	5.6%	2.2%	3.1%	-3.0%
U.S. CPI	2.2%	2.8%	2.7%	-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

On-Going Operating Revenue Performance

From FY1997 to FY2008, total state-source School Aid Fund revenues grew from $8.6 billion to $11.5 billion, an increase of 34 percent, equal to an annualized rate of 2.7 percent. This average growth rate was equal to the annual rate of change in the U.S. Consumer Price Index (CPI) over the same period, but slightly below Michigan personal income growth (3.1 percent per year). Viewed over the entire period, growth of the SAF appears to have fared relatively well; however, this picture changes significantly when the component pieces of the Fund are dissected and the period is broken into three sub-periods corresponding to Michigan' economic performance (See **Table A**).

During the initial years following Proposal A's adoption, state operating revenue growth was strong due to the strength of major tax collections, but per-pupil revenue growth was moderate because of rising student enrollments. Causes of Michigan's weak state education revenue growth from FY2001 to FY2008 include the mild 2001 recession and economic restructuring and, to a lesser extent, tax policy changes that effectively narrowed the bases of major taxes dedicated to funding schools. The tepid growth of the major taxes was not observed in per-pupil funding levels as this period was marked by declining student enrollments. In contrast to the first two sub-periods in which state revenues exhibited some degree of growth, revenues over the current period (FY2009 and FY2010) will decline in response to the Great Recession's impact on the Michigan economy, the first such occurrence since Proposal A. The very severe national recession has established the new "base" level of state funding from which future state revenues will grow.

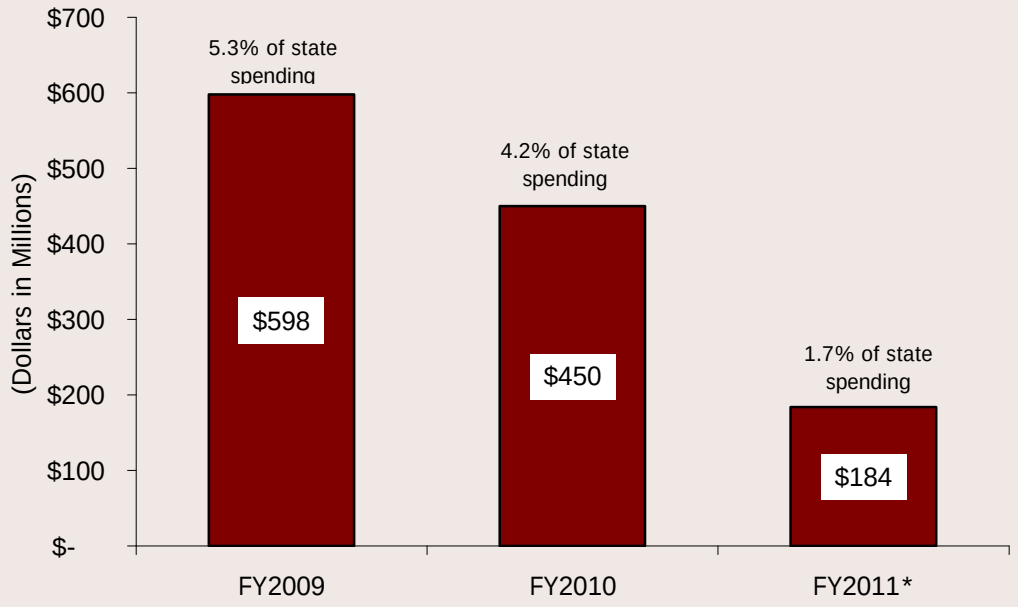
Annual changes in minor state education taxes have been influenced by a number of factors different from those which affected major tax receipts. Growth of these taxes benefited from a number of tax rate increases and the adoption of new taxes.

At the same time that growth in dedicated tax revenues has been slowing or declining (FY2001 to present), the annual General Fund allocation to schools was pared back and funding responsibility for certain items shifted from the General Fund to the School Aid Fund. The "safety value" previously available to finance schools and provided by the General Fund was effectively shut off as discretionary resources were re-allocated to other areas of the state budget in the annual appropriation process. Today, discretionary state funds do very little to supplement dedicated education revenues. Future General Fund allocations to schools will be tied to the performance of General Fund taxes, the composition of which is different from the state School Aid Fund.

In contrast to the ebbs and flows of state sources over last decade, local operating revenues have exhibited steady growth dating back to 1995. Stability

was provided by the property tax, which varies little over the business cycle vis-à-vis consumption and income taxes. Until recently, the appreciation in the property tax base was not adversely affected by changes in the Michigan economy; however, the bursting of the housing bubble is affecting property values and property tax growth has stopped. The long-term challenges facing the property tax as a revenue source for schools relates to state tax limitations that will constrain tax base growth during the eventual real estate market recovery.

Chart B
ARRA Funds Used to Achieve SAF Budget Balance: FY2009 through FY2011



* Based on Enacted FY2011 budget (Public 110 of 2010).

Tax revenues, especially those based on economic activity, will always be subject to the ups and downs of the business cycle, but public finance systems can be designed to moderate such volatility through the composition of tax sources. Operational support for Michigan's public schools comes from a balanced mix of major tax sources (consumption, income, and property) with no single source being dominant. Stability is further enhanced through earmarking of state revenues and indexed growth rates for some minor tax sources (i.e., Michigan Business Tax). Michigan's system of state and local school finance exhibits greater revenue stability than the state's General Fund.

Non-recurring Resources Supporting Schools

Schools have not had to deal with the full effects of stagnating and declining state resources because state policy makers have provided substantial amounts of non-recurring resources to maintain education spending levels since FY2001. Initially, accumulated reserves, both School Aid Fund and Rainy Day Fund, were used to augment on-going revenues. Additionally, a one time change involving the collection of the statewide property tax was enacted to increase cash receipts in one year (effectively reducing receipts in the next year). At the local level, districts have been drawing down fund balances to maintain programs and to reduce the level of annual spending cuts in response to state aid performance.

Recently, the state and local operating revenue declines in FY2009 and FY2010 will not be fully reflected in the level of education services delivered. The $934 million (8.2 percent) reduction in state-dedicated funding in FY2009 will be partially offset by the availability of temporary funding provided through the 2009 federal "stimulus" legislation. Significant levels of non-recurring federal monies are being used in FY2009 and FY2010 (**Chart B**). Michigan will be receiving additional federal resources ($318 million), through another new "stimulus" program, to prop up the FY2011 School Aid Fund budget. The fiscal effects of Michigan's heavy reliance on substantial amounts of one-time and temporary

funding are that they produce revenue "cliffs" in the out-years and perpetuate an imbalance between on-going resources and on-going spending. These resources do nothing to achieve structural balance in Michigan education finances.

Long-Term Fiscal Imbalance

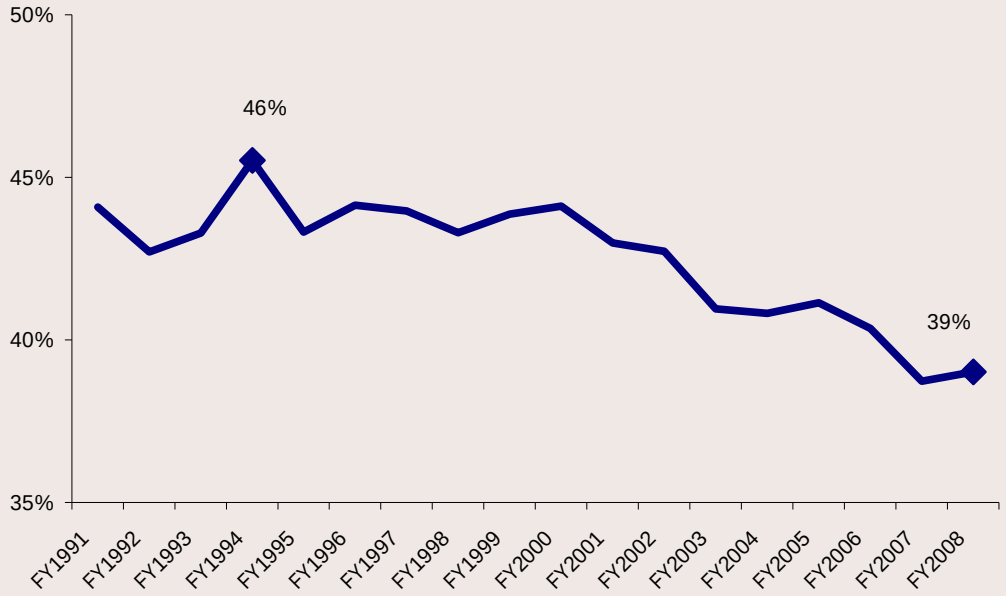
Recent events have focused attention of policy makers and taxpayers on the revenue volatility as it relates to state taxes and funding for public services, particularly public education and the $165 per-pupil reduction that occurred in FY2010. These current events, however, obscure a more fundamental, long-term problem that plagues K-12 education finances in Michigan. Since the early 2000s, the state has failed to come to grips with the dual structural deficits affecting its major operating funds, General Fund and School Aid Fund. Instead of fixing the problems in a permanent, sustainable fashion, the state has relied on a series of "stop gap" measures dating back to FY2001 to achieve budget balance.

CRC's previous efforts to scope and quantify the structural budget deficit facing public education reveals that spending pressures at the local level are expected to grow at a rate of 4.7 percent annually, while operating revenues (based on current tax structure and moderately improving economic climate) are projected to growth 3.0 percent per year. Long-term challenges on both sides of the budget ledger contribute to an estimated 1.7 percentage point difference between spending pressures and available resources (about $400 million annually over the forecast period). Specifically, personnel costs driven primarily by health care spending for current and retired school employees along with wage and salary increases will contribute to the growth on the expenditure side. The expected future growth in school revenues will be influenced by the relationships between the state's economic base and the taxes dedicated to financing, along with tax policies that narrow the base of these taxes.

Enhancing Stability in Education Finances

Emerging from the Great Recession, state policy markers and Michigan citizens should focus their attention on the long-term prospects for school funding. Despite the relative stability of school finances vis-à-vis the state's General Fund, at least in the short-run, long-term growth of the education financing system will not match economic growth because of the current tax structure and projected economic and demographic trends. Individuals are receiving a greater portion of their income from nontaxable sources. Consumers are purchasing an increasing amount of untaxed services in relation to taxed goods and they are avoiding the use tax through Internet and remote purchases (**Chart C**). The state's work-

Chart C
Taxable Sales as Percent of Personal Income: FY1991 to FY2008



Source: State of Michigan, Comprehensive Annual Financial Reports; U.S. Department

ing-age population is shrinking, while the general population is aging at a faster rate than other states, which will likely reduce tax receipts because older residents have different consumption preferences. Also, older residents receive more of their income from untaxed sources such as pensions and transfer payments (i.e., Social Security).

As the economy continues to transform and if the school finance system remains unchanged, the link between state education revenues and economic activity will continue to weaken. Policy actions will be required to "re-connect" the school funding system with the direction of the Michigan economy if tax receipts are to grow commensurate with broad measures of economic activity. Furthermore, legal provisions superimposed on property taxes (state and local) will accentuate the disconnect between overall education revenue growth and what is taking place in the economy as property tax receipt growth will experience a drag associated with the deterioration of the tax base. Without state revenue restructuring or attempts to address various and inter-connected property tax limitations, the delivery of public education services will have to be re-calibrated to match a revenue system that grows more slowly in the future, because the option to influence overall revenue growth vial the local property tax is extremely restrained.

Repairing the weakened relationships between state education taxes and the economy will enhance the current level of stability in the education finance system. Specific actions to enhance stability will have to focus on the major sources of school funding, both state and local taxes. At the state level, broadening Michigan's consumption tax base to include the growing service sector is likely to enhance revenue stability and preserve the long-term sales tax yield. A broad-based consumption tax would also provide some protection during recessionary periods against wide fluctuations in yields associated with a goods-dominated tax. Re-configuring the sales tax base entails a host of complex issues (i.e., administrative, equity, definitional), including the decision whether a net tax increase or a net tax decrease is a desired end-product.

Changing the projected growth path of the income tax will require modifying the rate structure, deductions, and/or credits. If Michigan were to substitute a graduated income tax for its current flat rate tax, considerable additional growth in revenues could be realized because income growth over much of the last half-century has been concentrated in high income earners.

To modify the projected growth path of the 6-mill State Education Tax coming out of the period of declining tax base would require a statutory change in the tax rate or changes to the Michigan Constitution to alter the modified acquisition value system of property valuation. For local school operating taxes, policy marker will have to confront the complex relationships of Michigan's various property tax limitations. Proposal A did not amend the Headlee Amendment's property tax limitations, nor did it specify how the Headlee Amendment provisions should be applied to the new measure of taxable value and "pop ups" in value (following transfer of ownership). The resulting statutory implementation of these limitations has had a compounding affect creating greater aggregate limitation than either Headlee or Proposal A was designed to achieve individually. One response that would enhance stability would involve redefining the tax base "growth" to exclude "pop ups" to allow the tax base of existing property to grow at a rate that approximates, or slightly exceeds, inflation. Another option would be to provide for the effective exemption of the "required" local school operating millage (18 mills in most cases) from the Headlee tax rate "roll back" provisions.

Finally, some contend that the school finance system's primary failure is the lack of local options to raise operating revenue, separate from the "required" local taxes. One option that could provide additional stability to school finances, at least at the individual local level, would be to allow districts to ask voters for additional millage, subject to a state-determined cap. The current ISD-wide enhancement millage could be eliminated or modified to effect more local choice over the ultimate level of financial resources available to each district annually.

State and Local Revenues for Public Education in Michigan

Introduction

Public K-12 education in Michigan provides a prime example of the federalist system, complex governance, and intergovernmental finance systems. Despite shared responsibility among levels of government, strong language in the 1963 Michigan Constitution entrusts the state government with ultimate authority over public K-12 education. The Constitution further allocates authority and responsibility among the executive and legislative branches of state government, as well as the constitutionally created state board of education. Although plenary power over educational matters rests with the state government, considerable authority has been delegated to local school districts, especially functions dealing with the delivery of elementary and secondary education services. Financing education is one very important area where authority is highly centralized at the state level, specifically with the legislature, and where there is little local decision-making responsibility. [Note about term "education": Michigan state government finances, via the legislative appropriations process, education services provided at various governmental levels and through many different entities. Hereafter, references to "education" are meant to refer to public K-12 education provided through traditional local and intermediate school districts, as well as public school academies, unless otherwise specified. The term does not include private or parochial education.]

Financial support for public education in Michigan continues to be a major public policy issue, despite the fact that significant resources are dedicated to serving nearly 1.7 million children each year. In state Fiscal Year 2007-2008 (FY2008) Michigan schools received $16.2 billion in state and local revenues for on-going operations.[1] This total does not include $1.5 billion in federal revenues and nearly $1.9 billion in state and local revenues spent on capital projects. State and local revenues supporting education equaled 4.6 percent of Michigan personal income in 2008. Education is a priority, but there are concerns that public education is currently under-funded and that, prospectively, spending pressures will outpace the resources available each year. There is further concern that state and local resources are distributed inequitably among Michigan school children.

Some of the current concerns about financial support for education can be better understood in the context of the financing system and its components. Focusing on the system's design and the economic, political, and demographic factors affecting it, provides valuable insights into the outputs it generates, such as the level of resources in the aggregate or on a per-pupil basis. These outputs, however, do not directly translate into specific educational outcomes. Michigan's education financing system is influenced by a variety of factors, most notably the underlying economic bases upon which public revenues (primarily taxes) are derived, demographic changes, and modifications to state law. Because of the predominant role played by state government, Michigan's education finances also have to be understood in the larger context of aggregate state finances.

Prior to the approval of Proposal A in March 1994, the responsibility for funding schools and the decisions regarding annual resource levels were the province of local officials and residents. Not surprisingly, in this environment, the experiences of Michigan's 550-plus districts varied widely. Two areas where inter-district differences were most stark were: 1) per-pupil revenue levels and 2) local property tax effort. Largely as a consequence of the growing disparities in these two areas, voters were asked nearly a dozen times over the 20-year period preceding Proposal A to amend Michigan's Constitution to address some aspect of the school finance system. Each time, change was rejected.

Unlike previous attempts at reform, the changes brought about by Proposal A represented a transformational, as opposed to a marginal, shift in the way school revenues were raised and how these revenues were distributed to local districts. The constitutional and statutory changes enacted in 1993 and early-1994 revamped Michigan's school finance

system by destroying the old one and ushering in a completely new one. The seismic nature of the reforms meant that elected officials in Lansing and in local communities, along with school officials and citizens, had little experience with the operations of such a system. Thus, in a real sense, the new financing system was an experiment.

Today, the financing for Michigan's education system is extremely centralized at the state level. Resource availability, both in terms of local and state revenues, is governed largely by decisions rendered in Lansing. At the same time that budgetary resource decisions are set centrally, nearly all spending determinations remain at the local level with a couple of noteworthy exceptions (e.g., retirement benefits funding). For many local school districts, operating under such a system has posed challenges in recent years. Such a "command and control" finance system leaves few options available for raising additional revenues, regardless of local preferences for education services. In this sense, today's system stands in marked contrast to that which existed prior to the 1994-95 school year.

Most of the recent discussion on school finance and recommendations for change focuses on the level of state financial support for education. Central to this discussion is the slowdown in state School Aid Fund revenue growth due to the nearly decade-long recession Michigan has experienced. Michigan's budget problems began with the mild 2000-2001 recession from which the state economy never fully recovered, and the transformation of Michigan's manufacturing-dependent economic base, which accelerated during the 2000s. These factors materially affected major tax revenue growth, especially in comparison to the experience of the 1990s. The changes in state revenue growth, combined with tax policy changes enacted during the late-1990s and early-2000s, negatively affected the state's ability to increase support for education throughout the decade. Recently, the Great Recession decimated state tax revenues from all sources, including those dedicated to the School Aid Fund. The revenue picture facing Michigan schools over the last ten fiscal years is much different than the picture immediately following the Proposal A reforms.

Looking forward and absent state policy changes, state support for education will be contingent on Michigan's recovery from the Great Recession. Both the strength and duration of a recovery will be factors in determining the level of state resources in the near term. Future revenues will continue to be affected by the decline in property values and the contraction of the tax base. The mechanics of the foundation allowance program will put additional strain on state resources to make up for lost property tax revenues at the local level in order to avoid future per-pupil funding reductions. Given the current system's limits on local districts' ability to raise local property tax rates for operations, greater significance is placed on state revenue performance going forward.

Current Financing System: Historical and Descriptive

The origins of the current education financing system date back to before the enactment of a series of reforms in 1993 and 1994 and have as their roots a number of failed attempts at finance reform throughout the 1970s and 1980s and stretching into the early 1990s. While pieces of today's school financing system resemble components espoused in earlier attempts at school finance reform, the current system is unique in its content and scope. And while the origins of today's education finance system can be traced to a long history of contemplated constitutional and statutory changes, the most significant event in the history of the current system dates back to a single legislative action that occurred in 1993.

The origins of the current education financing system date back to before the enactment of a series of reforms in 1993 and 1994 and have as their roots a number of failed attempts at finance reform throughout the 1970s and 1980s and stretching into the early 1990s.

Michigan's most dramatic step toward education finance reform occurred in the summer of 1993 with the elimination of the property tax as the primary revenue source for funding local school operations. This bold step was taken without an alternative funding mechanism identified to replace the lost revenue. Furthermore, Senate Bill 1 of 1993 (PA 145) did not embrace any other issue related to the concerns surrounding Michigan's school finance system at the time, i.e., issues dealing with property tax base growth, assessments, etc. Despite its limited scope, the complete elimination of the main source of school operating revenues effective for FY1995 was enough to spur five months of in-depth deliberations that would eventually break the 20-year impasse on school finance reform. By the end of the 1993 calendar year, the Michigan Legislature had completed work on a new school funding allocation method, abandoning the power-equalization system for a per-pupil foundation system. The only unresolved piece of the reform picture was how to finance the new system. This question was left to the Michigan electorate to decide in the spring of 1994 at a special statewide election. Michigan voters opted for a plan to increase the sales tax and other minor taxes over an alternative statutory plan that was based on an increase in the individual income tax rate and single business tax rate.

Elimination of the Property Tax and the New Revenue Structure

Public Act 145 eliminated all property taxes for local school operating purposes effective with the 1994 calendar year and the 1994-95 school year (state FY1995). The Act exempted all property from local and intermediate school district (ISD) operating millages, but did not affect debt and building and site millages. Further, community college millages were specifically excluded from the exemption. The legislation made no provision for the replacement of the lost revenue, estimated to total $6.9 billion in 1994 for all units of local government affected (See **Table 1**).

The elimination of the local property tax for school operations resulted in substantial property tax re-

Table 1
Property Tax Reduction under PA 145 of 1993
(Dollars in Millions)

School districts:	
Local K-12	($6,020)
ISDs	(510)
Fiscal impact of assessment freeze	(128)
Tax abatements and tax increment financing	(180)
Property tax administrative fees	(39)
Total property tax reduction	($6,877)

Source: Michigan Department of Treasury

lief. The average statewide property tax rate (all levies) in 1993 was 56.64 mills and the average school operating millage rate (33.91 mills) constituted 67 percent of this total figure. The highest school operating millage was 45.67 mills and the lowest 7.8 mills. Fifty-three districts (10 percent of the total) had rates of 40 mills or higher and 257 districts (49 percent) levied millages at or above the statewide average tax rate. From a tax rate perspective alone, PA 145 resulted in a monumental property tax rate cut.

As a result of the property tax elimination, local school districts lost an estimated $6 billion and ISDs lost $510 million. It is estimated that the property tax accounted for nearly two-thirds of the total $10 billion in combined state and local support for local district and ISD operations in FY1994.

The option to increase state taxes to fully replace the lost locally derived revenues faced legal, political, and administrative constraints. Of particular note was the state revenue limit of Article IX, Section 26 of the 1963 Constitution.

The repeal of the local property tax as the primary funding mechanism for public education raised a number of questions. Chief among these was the question of how the revenues would be replaced. A number of previous attempts at school finance reform over the preceding 20-year period aimed to replace a portion of the property tax with an increase in a state tax, most often the sales tax. Given the sizeable loss of local revenue brought about by PA 145 ($6.9 billion), it would have been impossible to achieve even partial replacement without heavy reliance on one or more of the four major state taxes in effect at the time: single business, individual income, sales and/or use. Another option would have been the creation of new tax, such as a statewide property tax.

The option to increase state taxes to fully replace the lost locally derived revenues faced legal, political, and administrative constraints. Of particular note was the state revenue limit of Article IX, Section 26 of the 1963 Constitution, which limits the amount of state revenue that can be collected in any state fiscal year to a set percentage of state personal income. Michigan was nearly $3.2 billion below the state revenue limit in FY1993, the last full year prior to the reforms, however, this was far short of the needed amount to fully replace the $6.9 billion in lost local property tax resources.[2] Given this legal constraint, the legislature needed to rely, to some degree, on a local tax source to secure full replacement of the lost local property tax revenue. Further, because of the limited revenue options available to local school districts and the use of the property tax in the past, some type of local property tax was going to be part of the final revenue picture for schools.

Adjusting the Revenue Limit to Accommodate the Shift in Education Funding

In addition to establishing a state revenue limit and describing the mechanics of the limit, Section 26 of Article IX also provides for the adjustment of the limit if programs are transferred from one level of government to another. Such a transfer has to occur as a result of a constitutional amendment and the total amount of state and local revenue collected after the change cannot exceed the amount that would have been authorized without such a change. In other words, an increase in state revenues has to be accompanied by an equal or greater reduction in local revenues. The inclusion of this provision in Section 26 recognized the fact that responsibility for the provision of public services can change over time.

The major shift in financing public education services from the local level to the state level contained in both the statutory and constitutional plans of the mid 1990s could have triggered an adjustment to the Section 26 revenue limit. The school finance reform proposals did not broach the topic of adjusting the Section 26 revenue limit; therefore, the issue of replacement revenues resulting from PA 145 was constrained by the existing state revenue limit.

Another constraint on revenue replacement was the constitutional limitation on the maximum state sales tax rate. Article IX, Section 8 of the Michigan Constitution prohibited the legislature from imposing a sales tax of more than four percent. In order for the legislature to be able to raise the sales tax rate, voter approval was needed.

The Michigan Legislature responded to the passage of PA 145 on two distinct fronts. First, it engaged in an effort to redesign the mechanism for distributing education funding. A primary goal of this effort was to address the per-pupil financial disparities that existed under the pre-1993 funding model. There was a general consensus that this objective could be achieved through centralizing, at the state level, the system for determining annual per-pupil revenue amounts. This would require the abandonment of the power-equalization method in favor of a per-pupil foundation grant. The Legislature completed its work on the new per-pupil foundation program in late December and the Governor signed the package of bills on December 31, 1993.

Proposal A established the first-ever per-pupil revenue floor for schools in Michigan, beginning in FY1996. The FY1996 per-pupil funding floor was set equal to each local district's combined state and local per-pupil operating revenue in FY1995.

The second area of legislative debate following passage of PA 145 dealt with financing the new system. During the months that followed adoption of PA 145, the Legislature developed two revenue replacement proposals. The main component of the first plan involved amending the Michigan Constitution to raise the sales and use tax rates from four to six percent. The backup statutory plan relied on a combination of increased income and single business tax revenues. Both plans shared similarities, but also exhibited key differences. In March 1994, voters were asked how they preferred to pay for the new school funding model developed by the Michigan Legislature. The two choices presented to the voters did not allow for a continuation of the existing system, something previous attempts had provided for and which voters opted for every time.

At a statewide special election held on March 15, 1994, Michigan voters approved the ballot proposal (Proposal A) and its method for funding schools going forward. Proposal A amended a number of sections of the 1963 Michigan Constitution related to financing public elementary and secondary education:

- Allowed school operating taxes to be imposed on a non-uniform basis as to rate, allowing owner occupied homes to be taxed at a lower rate (Article IX, Section 3).
- Limited assessment increases on individual parcels of existing property to the lesser of five percent or the rate of inflation beginning in 1995 (Article IX, Section 3).
- Increased the state sales tax rate from four to six percent, beginning May 1, 1994, and dedicated the additional revenue to the School Aid Fund (Article IX, Section 10).
- Guaranteed that each local school district, beginning in FY1996 and thereafter, would receive at least as much combined state and local operating revenue per pupil as it did in FY1995 (Article IX, Section 11).
- Required a three-fourths vote of the legislature to increase school operating tax rates above those in effect on February 1, 1994 (Article IX, Section 3).[3]

Proposal A established the first-ever per-pupil revenue floor for schools in Michigan, beginning in FY1996. The FY1996 per-pupil funding floor was set equal to each local district's combined state and local per-pupil operating revenue in FY1995. Under the new language, the new per-pupil funding floor does not apply to any district in any year in which the district levies a school operating millage rate less than it levied in 1994. The Constitution did not prescribe the method for funding the new per-pupil floor as this was detailed in the statutory changes that accompanied the ballot proposal.

Proposal A also added a new vote threshold to increase school operating taxes (Article IX, Section 3). This new language requires a super-majority (three-fourths) approval of the members of both the Michigan Senate and House of Representative to pass a

law that increases operating taxes above the level in existence on February 1, 1994. Previously, the Michigan Constitution did not contain any special provision regarding the passage of laws related to school operating taxes.

The approval of Proposal A triggered numerous changes in state tax law to supplement the constitutional increase in the sales taxes used to finance the new education funding system. Changes affected both the local district contribution and the state aid payment portion of the new foundation allowance. These changes are summarized in **Table 2**.

The new legislation enacted subsequent to Proposal A's passage restored a portion of the local operating property tax for local school districts, but at a significantly reduced level. Additionally, property taxes for operating purposes were levied at the state level for the first time. The new state property tax (State Education Tax) took effect in 1994, was levied at the rate of 6 mills, and applied to all property classes.

The Michigan Legislature fully restored the three types of operating taxes used to finance intermediate school districts (general operating, vocational-technical education, and special education); however, statutory caps were placed on the maximum tax rate for each type of tax, subject to local voter approval.

The local property tax also took effect in 1994 with the base limited to property classified as business, including rental housing, and second homes. The rate of the new "non-homestead" tax was capped at 18 mills or the rate in effect in 1993, whichever was less. The proceeds from the local property tax were retained locally and used as the first dollars toward funding the new per-pupil foundation allowance. In addition to these primary operating taxes, state law allowed some higher-spending school districts to levy additional mills, known as "hold-harmless" mills, to maintain their higher level of spending. The only supplemental local operating tax available to all districts was a three-mill enhancement tax. Authoriza-

Table 2
Statutory Tax Changes of School Finance Reforms

	Pre-Proposal A	Post-Proposal A
New Taxes		
State Education Tax (property)	None	6 mills on all property
State Real Estate Transfer Tax	None	2 percent**
Other Tobacco Products Tax	None	16 percent of wholesale price
Tax Rate Changes		
Local property tax	8 - 40 mills (varied by district)	18 mills on non-homestead property*
Individual Income Tax	4.6 percent	4.4 percent
Use Tax	4 percent	6 percent
Cigarette Tax	25 cents per pack	75 cents per pack
Tax Base Changes		
Use Tax – interstate phone calls	None	Included

Notes:

* Or the rate levied in 1993, whichever is less

** Public Act 330 of 1993 created the new tax and established the rate of $10 per $500 (two percent) of value of property transferred; however, before it took effect, the rate was changed to $3.75 per $500 (0.75 percent) of the property value under PA 3 of 1994.

tion for districts to levy this millage expired after 1996 and was replaced by a three-mill regional property tax levied at the intermediate school district level.

Proceeds from other state taxes were dedicated to the School Aid Fund. A new state-level Real Estate Transfer Tax (rate of 0.75 percent of the value of property) was created. [Note: This new tax accompanied an existing county-level real estate transfer tax, levied at 0.11 percent of the value of property.] The use tax rate was increased by two percentage points to 6 percent to complement the constitutional sales tax rate increase included in Proposal A. The use tax base was also expanded to include certain interstate phone calls. A tax on non-cigarette tobacco products was enacted at a rate of 16 percent of the wholesale prices. The cigarette tax was increased by 50 cents per pack (to a total of 75 cents per pack). Finally, the personal income tax rate was reduced on May 1, 1994, at the same time that the sales and use tax rates increased to 6 percent. Beginning October 1, 1994, 14.4 percent of the gross personal income tax collections were deposited in the School Aid Fund.

Michigan's school finance reforms changed the fiscal and tax landscape on a number of fronts. As a result of the property tax cuts, Michigan's property tax burden fell to below the U.S. average.

Impacts of Michigan's New Education Revenue Structure

Michigan's school finance reforms changed the fiscal and tax landscape on a number of fronts. As a result of the property tax cuts, Michigan's property tax burden fell to below the U.S. average. The sales tax burden increased relative to the national average and the overall composition of major taxes became more balanced. Changing the mix of state and local taxes also caused the financing system to be more centralized with a greater degree of state tax earmarking. Some of these changes were most pronounced immediately following the reforms and are still visible today, such as the high degree of funding centralization at the state government level. Other effects of the changes, such as the overall tax composition in the state, have slowly faded as a result of other tax policy changes and economic activity that has occurred over the years.

Property Tax Burden and Tax Composition

A specific goal of the school finance reforms was to reduce the reliance on property taxation to finance elementary and secondary education. Over the 20-plus years prior to Proposal A, a general consensus had developed that property taxes in Michigan were unduly burdensome. Although its total elimination as a funding source for schools, as contemplated under PA 145 of 1993, did not materialize, property taxes were reduced substantially as a result of school finance reform. The shift from the local property tax to the state sales tax helped achieve this objective without decimating the aggregate funding for schools.

Table 3
Statewide Ad Valorem Property Tax Rates and Levies: Pre- and Post-Proposal A

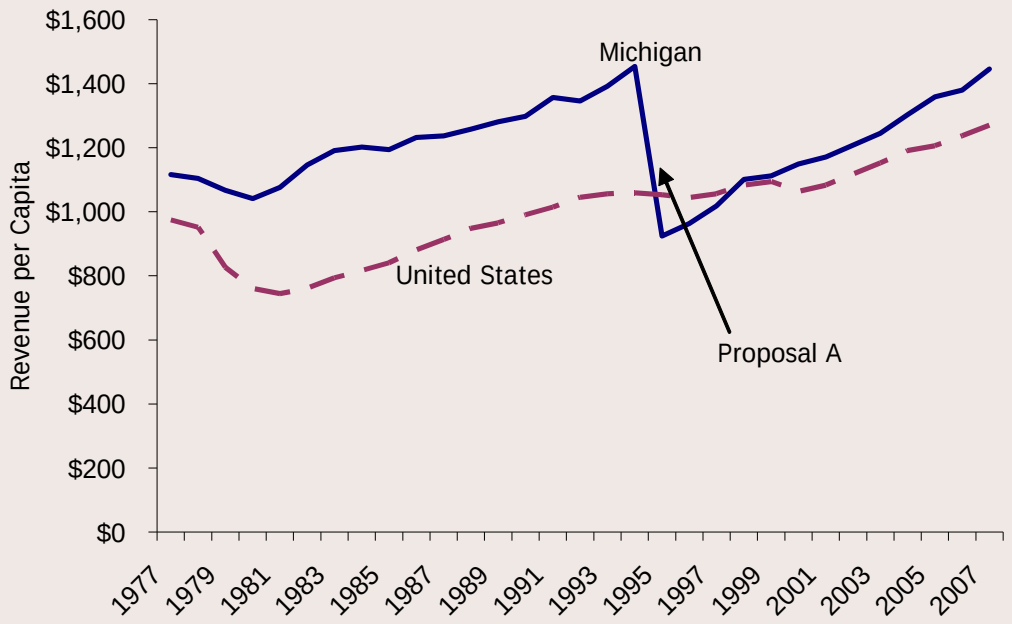
	1993			1995		
	Rate (mills)	Levy (millions)	Percent of Total	Rate (mills)	Levy (millions)	Percent of Total
Counties	6.22	$ 1,042.3	11.0%	6.28	$ 1,143.5	16.1%
Townships	3.36	283.4	3.0%	3.68	344.6	4.9%
Cities	15.45	1,288.0	13.6%	15.95	1,411.5	19.9%
Villages	11.94	50.7	0.5%	12.34	56.8	0.8%
Schools						
Operating	*33.91*	*6,381.3*	*67.2%*	*9.26*	*2,477.4*	*35.0%*
Debt and Site	*2.54*	*454.8*	*4.8%*	*3.03*	*554.5*	*7.8%*
ISD/Community College	*4.3*	*		*4.36*	*	
State Education Tax	*0*			*6.0*	*1,092.8*	*15.4%*
Subtotal	*40.75*			*22.65*		
Total	56.64	$ 9,500.5	100%	38.88	$ 7,081.1	100%

* ISD/Community College levy totals included in operating and debt totals.

Sources: State Tax Commission, Ad Valorem Property Tax Levy Report. Michigan Department of Treasury, Property Tax Report, 2007.

The overall reduction in Michigan property taxes is clearly seen in the comparison of statewide average tax rates and tax levies, immediately prior to and following Proposal A (See **Table 3**). The average total millage rate fell nearly 18 mills. The statewide average school operating millage rate fell from almost 34 mills in 1993 to just over 15 mills in 1995 (including the 6-mill State Education Tax), a 56 percent reduction. The amount of school operating taxes paid by Michigan property taxpayers, individuals and businesses, declined by $2.8 billion, from $6.4 billion in 1993 to $3.6 billion (including SET receipts) in 1995. The reduction also changed the composition of the overall property tax burden in Michigan. Previously, school operating taxes accounted for over two-thirds of the total property tax levy. Following the reforms, school operating property taxes (including the SET) made up one-half of the total.

Chart 1
Real State and Local Property Tax Revenue Per Capita
Michigan and U.S. Average



Source: U.S. Census Bureau

Chart 1 illustrates the change in Michigan's property tax burden relative to the U.S. average over the years. The effect of Proposal A is evidenced in the steep decline that occurred from 1994 to 1995. On a per-capita basis, Michigan residents were paying property taxes 37 percent higher than the U.S. average in 1994. In 1995, Michigan dipped to 12 percent below the national average. Since that time, Michigan's per-capita property tax burden has grown faster than the national average and now it is above the national figure (about 14 percent); though the difference is less than in 1994.

The chart also shows the disparate growth rates between Michigan and the U.S. as a whole, which were not materially affected by the Proposal A changes. Michigan's higher growth rate, both pre- and post-Proposal A, is a function of two factors. Michigan local governments are almost entirely dependent on property taxes for their own-source revenues. Where other states authorize their local governments to levy local-option sales, income, motor fuel, or payroll taxes, local governments in Michigan rely on state aid and property taxes. This is because these other taxes are prohibited or local governments have opted against using them. For example, only 22 cities have elected to impose a municipal income tax. Given the lack of revenue options for local government in Michigan, property taxes are the main source of revenue for cities, villages, townships, counties, K-12 schools, community colleges, and those special districts with taxing authority. Second, the Michigan assessment system endeavors to produce assessments that reflect current market value. Some states allow several years to pass between reassessments, resulting in slower growth of their property tax base.

The shift from the property tax to general sales tax as the major financing mechanism for education changed Michigan's overall tax composition. Tax composition, or tax reliance, refers to relative shares of each major tax type (e.g., property, sales, income, etc.). Because different levels of government have different responsibilities for funding public services in each state, both state and local tax data must be included in comparisons of tax composition. Failure to examine both state and local taxes can skew inter-state comparisons of tax reliance. A state's tax composition provides insight into the basic method and relative weight given to each major tax type. Michigan's relatively high property tax burden compared to other states prior to the school finance reforms was reflected in its tax composition at the time. Compared to the U.S. average, Michigan relied more heavily on property taxes and less on general (not selective such as motor fuel, tobacco, and alcohol) sales taxes to finance government services at the state and local level (See **Table 4**). After implementation of the school finance reforms in Michigan, property taxes constituted a smaller share of the total tax picture and the portion attributable to general sales taxes increased. Also, Michigan's overall tax composition more closely resembled the U.S. average figures. Since that time, however, the property tax burden has increased.

After implementation of the school finance reforms in Michigan, property taxes constituted a smaller share of the total tax picture and the portion attributable to general sales taxes increased. Also, Michigan's overall tax composition more closely resembled the U.S. average figures.

Table 4
State and Local Tax Composition, U.S. Average and Michigan

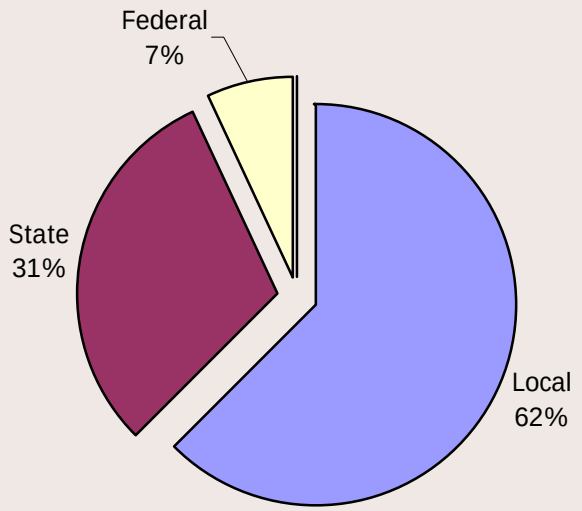
	1992		1997		2008	
	U.S.	Michigan	U.S.	Michigan	U.S	Michigan
Property Taxes	32%	44%	29%	29%	31%	38%
General Sales Taxes	24%	18%	25%	27%	23%	22%
Income Taxes	25%	26%	27%	32%	27%	25%
Other Taxes	19%	12%	19%	12%	19%	16%

Source: U.S. Census Bureau, State and Local Government Finances.

Notes:
1) "general sales " does not include "selective sales taxes", such as motor fuel, tobacco, alcohol , these are included in the "other" category.
2) "income" includes both "individual" as well as "corporate" income taxes as defined by the U.S. Census.

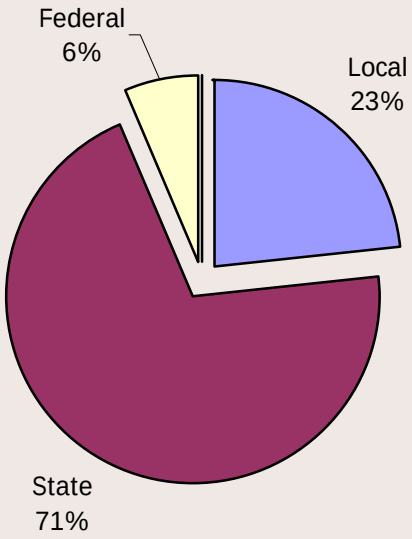
Numbers do not add because of rounding.

Chart 2
Operating Revenues by Source: FY1994



Source: National Public Education Financial Survey

Chart 3
Operating Revenues by Source: FY1995



Source: National Public Education Financial Survey

Centralized Revenue System

The school finance reforms centralized education revenue-raising responsibility at the state level, effectively eliminating a balkanized system at the local government level. This shift is clearly visible in the shares of total operating revenues by source supporting public education services in Michigan before and after the reforms (See **Charts 2** and **3**).[4] In the years leading up to the reforms the education finance system had been criticized on a number of fronts; however, its fragmentation became a clear rallying point for public displeasure when a district was forced to close early in 1993 because of its failure to garner public support for increased local property taxes to fund operations.[5]

State government's expanded role in education financing was accompanied by an increase in the portion of state revenues specifically earmarked for education and deposited in the School Aid Fund (SAF). Following the adoption of the reforms, the composition of the SAF changed dramatically as a result of new constitutional and statutory tax revenue earmarking provisions. Prior to the reforms, earmarked taxes (both constitutional and statutory) comprised slightly more than two-thirds of the total state-generated revenue going to the SAF in FY1993, with the remainder (about one-third) coming from the discretionary General Fund allocation, which were subject to the demands of the broader state budget. Following the reforms and after implementation of the increased income tax earmarking, the SAF was almost entirely comprised of dedicated state revenues and the General Fund played a much smaller role in percentage terms.

While the effects of centralization on the entire (statewide) financing system are clear from the percentage shares of each operating revenue source before and after the reforms, centralization also affected the relationship between state and local revenues received at the individual district level. This can be seen in the functioning of the per-pupil foundation grant. The grant amount for each district each year was determined at the state level (either by statute or legislative decision) and this amount was guaranteed, regardless of the performance of the school operating property at the local district level. State aid was provided to make up the difference between

the per-pupil grant amount and the per-pupil operating tax revenues generated by the 18 mills.

Less clearly visible in the "state" and "local" revenue breakout immediately after Proposal A is the fact that the new school finance system subjected "local" property tax revenues to strict controls. Given these controls, the "local" property taxes, especially the 18-mill non-homestead tax, were effectively state-level taxes. Existing constitutional limits on property tax growth were added to by both constitutional and statutory changes that accompanied the new school financing system. The new tax limitations pertain to both the rate and base components of the local property taxes authorized for school operations. Further, the new system provided little opportunity for local voters to supplement funding derived through the per-pupil foundation grant (i.e., combination of state aid and the "required" non-homestead local property taxes.)

State limitations capped the maximum rate of the local operating tax for local schools at 18 mills for most districts. For intermediate school districts, the rates of the three property taxes used to support programming and services (i.e., general operating, special education, and vocational-technical education) were subject to separate caps based on the rates levied before Proposal A (i.e., 1.5 or 1.75 times the 1993 rate, depending on the specific tax). While local and intermediate school district property tax rates were capped as to their maximum level, they were subject to the "Headlee" tax rate rollback provisions of the Michigan Constitution contained in Article IX, Section 31.[6] Subjecting these taxes to this constitutional provision meant that the maximum rates, after being initially approved by the local voters, were not guaranteed indefinitely. Instead, tax rates could be reduced based on tax base growth and remain at their lower level until voters approved an "override" vote of the previous tax rate rollback. For local districts, adding to the sense of centralization is the fact that, under the foundation program, it is assumed that the full 18-mill tax is being levied and state aid funding is distributed on this assumption; however, in many cases, a portion of these mills have been rolled back pursuant to state law. Thus, while the state sets the per-pupil funding level and the required tax effort to achieve this funding amount each year, state law effectively prevents local districts from receiving their full foundation amount when tax rates have been reduced and the state does not make up for the previous rate rollbacks.

> Taken together, the direct (e.g., shift from local to state revenues) and indirect (e.g., new tax limitations and limited opportunity to supplement) effects of centralization resulted in a school finance system that, for all intents and purposes, is best characterized as almost entirely state-run in terms of the level of operating revenues available each year.

Existing and new tax base growth limitations contributed to the level of centralization in the new school finance system. Constitutional tax base growth limitations at the unit-wide level, already in place as a result of the Headlee amendment, were added to by Proposal A's tax base growth cap at the individual parcel level. Proposal A instituted a per-parcel growth limitation, which effectively controlled the growth potential of the tax base at the local level.

Proposal A permitted very little supplementation of existing resources with other operating taxes, which added to the amount of centralization present in the system. Only traditionally high-spending local districts were able to levy "hold harmless" millages to maintain the above-average per-pupil resource levels; however, these millages were strictly controlled by state law. During a brief transition period (tax years 1994 to 1996), all local schools were able to levy "enhancement" millages at the district level, with the proceeds of such a tax retained entirely by the district. This tax was replaced by a regional tax (intermediate school district), beginning in tax year 1997, that involved tax base sharing among districts and required tax revenues to be shared equally on a per-pupil basis. Under both "enhancement" millage authorizations (pre- and post-1997), the maximum rate was capped in state law at three mills, thus limiting the potential level of revenue supplementation. Intermediate school districts were not provided with any additional source options to supplement existing resources following the Proposal

A reforms, but they were provided additional room to raise tax rates above those in effect in 1993 for all three existing sources.

Taken together, the direct (e.g., shift from local to state revenues) and indirect (e.g., new tax limitations and limited opportunity to supplement) effects of centralization resulted in a school finance system that, for all intents and purposes, is best characterized as almost entirely state-run in terms of the level of operating revenues available each year. This centralization is apparent both when operating revenues are viewed in the aggregate at the statewide level and when they are examined at the individual district level. Despite the fact that "local" property taxes are levied, collected, and retained by individual districts, the amount of these resources is controlled by tax base and tax rate limitations established in the Michigan Constitution and contained in state law. As a result, the "local" resources under the current funding mechanism could be described more accurately as "state-controlled" revenues. When these "local" school operating property taxes are considered to be outside of the control of local officials, the breakout of "state" and "local" operating funding is much different – state-controlled revenues (directly or indirectly) comprise nearly 85 percent and local revenues comprise only six percent (**Chart 4**).

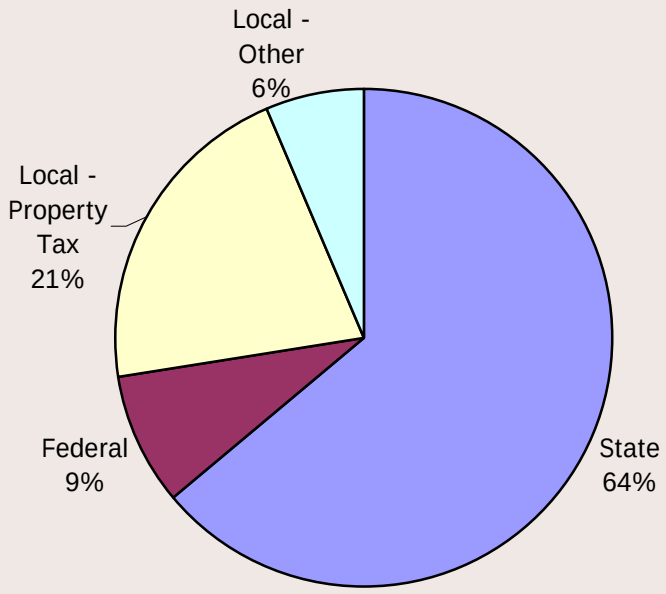
Adding to centralization, or at least the perception thereof, is the constitutional requirement that any law to increase school operating property taxes must be approved by three-fourths of each chamber of the Michigan Legislature. Proposal A did not define the term "school district operating taxes" and neither the legislature nor the courts have attempted to do so since the requirement was added to the Michigan Constitution.[7] Therefore, while the legislature can authorize an increase in the maximum tax rates for local and intermediate districts, doing so requires a super-majority vote which is more difficult to achieve.

State Revenue Limit

Shifting responsibility to the state level for education funding caused Michigan to approach, and slightly exceed, the constitutional state revenue limit in the years following Proposal A. Prior to the school finance reforms in FY1993, Michigan was $3.2 billion, or 19 percent, below the limit contained in Article IX, Section 26 of the 1963 Constitution. As noted above, there was no effort to modify the limit, as allowed under the provisions of Section 26, to accommodate the new financing system for K-12 education. The entire $3.2 billion gap between actual and allowable state revenues was eliminated with the increase in the various state taxes to fund schools.

In the first full year operating under Proposal A (FY1995), Michigan exceeded the limit by $110 million, or about 0.5 percent, the first time that the cap had been surpassed since the provision was added to the constitution in 1978. In the mid-1980s, the state approached the limit but never exceeded it.

Chart 4
School Operating Revenues by Source: FY2008



Source: National Public Education Financial Survey

The fact that the revenue cap was reached is evidence that further state support of the new school finance system was not possible without invoking changes to the limit itself.

The gap between actual revenue collections and the constitutional cap grew slightly over the next three years and was $640 million in FY1998. The cap was reached and slightly exceeded in FY1999 and FY2000, due to strong major tax revenue growth in these years. The experience of these two years prompted a series of phased-in tax rate reductions for Michigan businesses and individuals. These tax cuts, coupled with the concurrent general slowing of the economy in late 2000 and early 2001, caused actual state revenues to be $2.4 billion below the constitutional limit for FY2001. The gap between the limit and actual revenue receipts grew each year as the earlier tax cuts and subsequent ones, along with slow economic, limited revenue growth. State revenues were $5.3 billion below the cap in FY2007, before a series of general tax increases were enacted in late 2007 that narrowed the gap. In FY2009, actual revenue collections were $7.7 billion below the Section 26 limit as the economy soured again.

Spending Decisions Largely Untouched

Although the school finance reforms concentrated revenue-raising decisions at the state capitol in Lansing, spending decisions remained the province of local school districts with one significant exception. Responsibility for employer-paid retirement benefit funding was affected in a material way. In the post-Proposal A era, local school administrators and locally-elected school boards continued to be responsible for determining annual budgets and allocating state-determined resources among competing needs within districts. Local personnel are responsible for determining pay and benefits for current employees.

Prior to the implementation of Proposal A, the State of Michigan and public school districts shared in the financing of the employers' shares of contributions to Michigan Public School Employees Retirement System (MPSERS). Those contributions, expressed as a percentage of active employee payrolls, prefunded the actuarial costs of the defined benefit plan provided to public school employees plus the costs of health benefits for retirees on a pay-as-you-go basis. However, Proposal A changed the fiscal relationship between the state and local schools, by passing the full responsibility for financing the employers' contributions to the locals.

The new arrangement required the entire annual retirement contribution to be financed through a district's foundation allowance. This meant that this new fiscal responsibility was in direct competition with other spending pressures faced by school districts (wages and health insurance for current employees, fuel and utility costs, etc.). A district's ability to meet annual increases mandated by changes in the retirement contribution rate would be largely contingent on annual changes in the foundation allowance provided to the individual district. Every year, a system-wide contribution rate is determined for MPSERS, which is the same for each district and applied to each districts' active payroll; however, under the foundation allowance program, at least during the initial years following Proposal A's adoption, annual increases in per-pupil funding varied among the individual districts. Annual changes in the retirement rate are contingent on a number of factors, including the performance of the retirement investment portfolio relative to actuarial assumptions; the number of retirees drawing benefits; and the costs of health care increases. Annual changes in an individual district's foundation allowance were the result of policy decisions by state lawmakers. In an environment where a district's payroll and the retirement rate increase year-over-year, its foundation allowance would have to increase by the same combined percentage amount (assuming no change in enrollment) to ensure that the same percentage of the district's overall resources are available to finance retirement benefits from one year to the next. In such a scenario, if the foundation allowance does not rise by this amount, resources would have to be re-allocated from other budget components to satisfy the retirement contribution for the year.

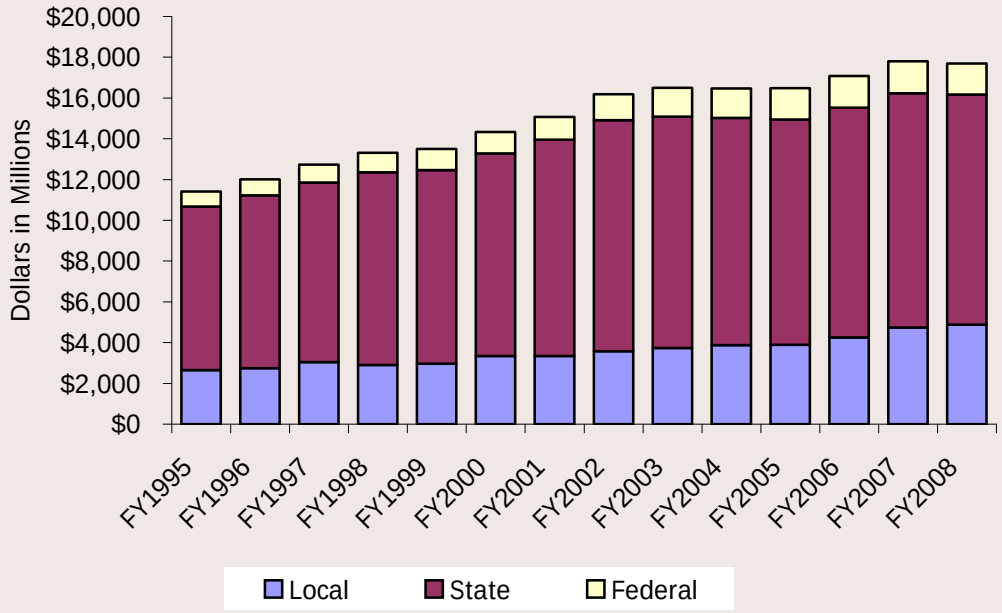
At the same time that Proposal A created a very centralized revenue, full responsibility for retirement funding was added to local districts' budgets, which effectively reduced the spending discretion at the local level. The real prospect that the retirement contribution rate would increase in future years (as it did in the first couple of years following Proposal A), meant that the per-pupil foundation allowance would have to rise commensurately to ensure that retirement contributions did not require greater shares of overall local budgets.

Education Finances Since Proposal A

Since the adoption of Michigan's current education finance system, state and local operating revenues, both in the aggregate and at the individual source level, have varied depending on the time frame of interest. The annual amount of revenues from federal sources has also varied: Because federal dollars represent, in the aggregate, a relatively minor share of the total and their use is restricted by federal law and rules, the main focus here is on state and local operating revenue performance.

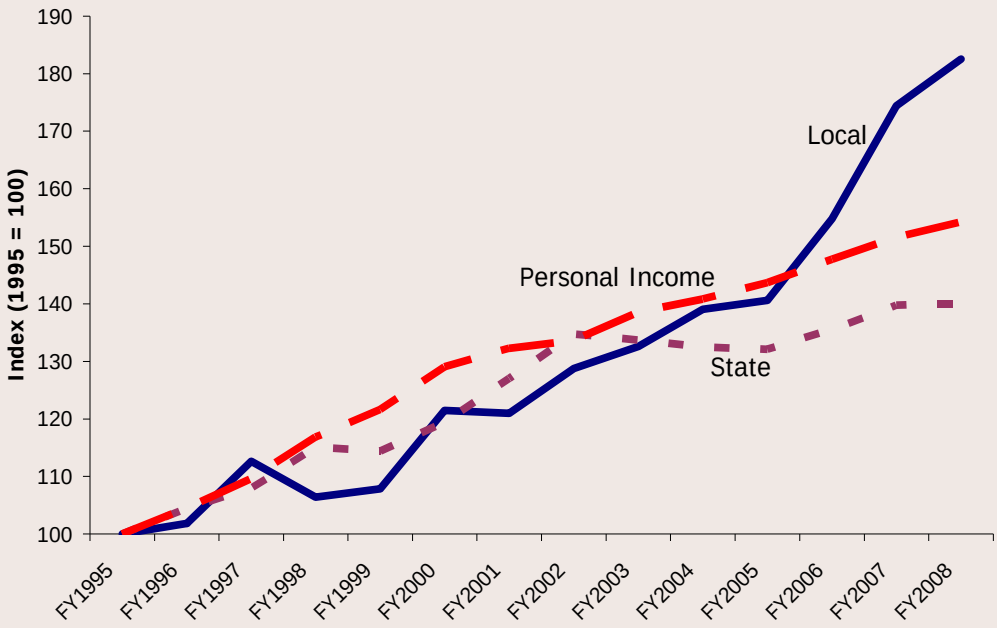
Between FY1995 and FY2008, the total amount of operating revenues from all sources (state, local and federal) increased from $11.4 billion to $17.7 billion, an increase of 55 percent, (See **Chart 5**).[8] This equates to a compound average annual growth rate of 3.4 percent over the 13-year period.[9] Total operating revenues grew at the same annual rate (3.4 percent) as Michigan personal income (a broad measure of economic activity in the state) and faster than the U.S. Consumer Price Index (a broad measure of the cost of goods and services), which increased at an average annual rate of 2.7 percent. Overall, operating revenues for Michigan schools in the aggregate, since the adoption of Proposal A, appear to have performed well based on these average annual calculations. This picture changes when the period is divided into distinct time frames and when operating revenues are scaled on a per-pupil basis by major revenue source (state versus local). Also, the performance of school revenues varies depending on the type of tax that is examined, e.g. property, income, sales, etc.

Chart 5
Operating Revenues by Source: FY1995 to FY2008



Source: National Public Education Financial Survey

Chart 6
Growth of State and Local Operating Per Pupil Revenues and Personal Income



Source: National Public Education Financial Survey; U.S. Department of Commerce; U.S. Department of Labor.

A better understanding of the resources available to educate children can be obtained by examining the revenues from state and local sources on a per pupil basis. **Chart 6** illustrates state and local per-pupil revenues and compares their growth to personal income growth over the period. While both major sources tended to track overall economic activity in the state in the early years following Proposal A, their paths diverge markedly beginning in FY1998. Growth of local per-pupil revenues remained strong through much of the early 2000s and accelerated in recent years, largely due to concomitant enrollment declines. On the other hand, state revenues, more acutely tied to overall economic activity in the state, basically plateaued in FY2002 and rose only minimally in recent years as a result of declining student enrollments.

The preceding discussion was designed to provide a very global picture of public education finances since Proposal A. The remainder of this section focuses, in more detail, on specific issues important to this global picture. The next section reviews Michigan's economic performance since 1995, the most important factor influencing state revenue growth. Next, public education spending is contrasted with the other spending financed by the General Fund. Attention is then given to the performance of both state and local revenue sources over the last 15 years. Finally, drawing on previous work conducted by CRC, a projection of public education finances in the future is presented.

Michigan's Economic Performance

State and local government finances have to be considered in the context of Michigan's economic performance. Economic activity affects public finances in a variety of ways, but the most visible is on the revenue side of public budgets. Taxes, which comprise the majority of resources for public budgets, are based on economic activity (consumption and payrolls) and wealth (property values). Taxes that are based on consumption or payroll activity are more sensitive to changes in economic performance than taxes based on wealth. These consumption and payroll taxes, collectively, provide the majority of resources for the State of Michigan's two main budgets, the General Fund and the School Aid Fund. As previously noted, property taxes play a much larger role in financing local government services in Michigan. Although diminished, property taxes continue to provide a significant level of operating assistance for local schools. As a revenue source, these taxes tend to be more stable relative to consumption and income taxes. This stability has helped moderate the volatility associated with the major state taxes supporting public education in Michigan. Tax revenue volatility general refers to cyclicality - the relationship between revenues and the business cycle.

Under Michigan's highly-centralized education finance system, the performance of the Michigan economy is a key determinant in the level of resources available each year, especially in light of the dominant role played by consumption and income taxes. Economic performance over the past 15 years (1995 through 2009) can be divided into three distinct time frames. State-source education revenues mirrored the performance of the broader economy during each period, which they were designed to do under the Proposal A financing system. The first period (1995 through 2000) was characterized by steady and stable economic growth, measured in terms of employment levels and the amount of income earned. In contrast, during the second period (2001 through 2008), employment levels declined and annual income growth slowed in nominal terms and in some years declined in real terms. Although Michigan was affected by the mild 2001 recession during this period, the fundamental economic problem which directly influenced public education finances centered on the complete transformation of the auto industry. The third and most recent period (2009 through today) is marked by a continuation of the job losses and income declines of the previous period, but at an accelerated rate because of the severe national recession that officially began in December 2007. The recessionary effects have been compounded by the fact that Michigan's economy continues to undergo a massive "rebalancing" (i.e., concentrated shift away from its traditional manufacturing base).

Under Michigan's highly-centralized education finance system, the performance of the Michigan economy is a key determinant in the level of resources available each year, especially in light of the dominant role played by consumption and income taxes.

Table 5
Michigan Wage and Salary Employment: 1995 to 2010*

Year	Employment Level (thousands)	Annual Change	Annual Percent Change
1995	4,269		
1996	4,352	83	1.9%
1997	4,439	87	2.0%
1998	4,513	74	1.7%
1999	4,585	72	1.6%
2000	4,676	91	2.0%
2001	4,564	(112)	(2.4%)
2002	4,487	(77)	(1.7%)
2003	4,416	(71)	(1.6%)
2004	4,399	(17)	(0.4%)
2005	4,389	(10)	(0.2%)
2006	4,326	(63)	(1.4%)
2007	4,267	(59)	(1.4%)
2008	4,162	(105)	(2.5%)
2009	3,876	(286)	(6.9%)
2010*	3,830	(46)	(1.2%)

Source: U.S. Department of Labor

* May 2010 Consensus Revenue Estimate

No single metric captures the entirety of a state's economic performance. However, two broad measures, when taken together, can paint a fairly clear picture of what is taking place in a state economically. Generally, measures of employment and income (both on total and per-capita bases) are used to describe the health of Michigan's economy over the years. **Table 5** summarizes the employment picture in Michigan. The variation in the annual change figures reveal the three separate periods previously noted. Michigan's total employment level grew each year between 1995 and 2000, averaging 1.8 percent per year. After peaking at 4.7 million jobs in 2000, the yearly total employment figure dropped to just under 4.2 million jobs by 2008, representing an annualized rate of decline of 1.3 percent. The employment pictured worsened during the 2008 recession as Michigan job losses accelerated and employment levels dropped almost another 300,000 jobs, or nearly seven percent, between 2008 and 2009. Current projections are for employment levels to continue to decline, but at a much lower annual rate in 2010 (-1.2 percent).

The Michigan employment situation looked very similar to the U.S. job market during the 1995 through 2000 period and early into the 2001 through 2005 period. Coming out of the brief 2000-2001 recession, the U.S. job market rebounded in 2004, but the Michigan employment level continued to decline throughout the mid- to late-2000s. The significant job losses in the 10-year period that began in 2001 has caused Michigan's job base to mirror what it was in the mid-1980s. While both U.S. and Michigan employment levels are off from their June 2000 peaks, Michigan has lost nearly 18 percent of its jobs compared to the nation, which has lost 0.7 percent.

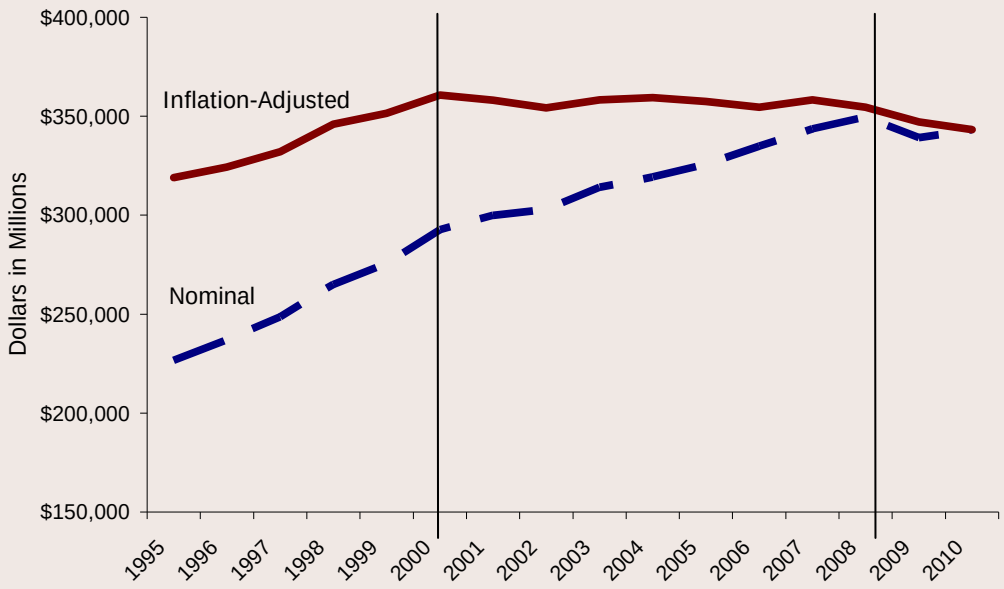
The loss of such a significant number of jobs is devastating for individuals and families. It is also important from a public finance perspective for two reasons. First, and most obvious, is the loss of eco-

nomic activity associated with the jobs. A reduction in the number of jobs directly translates into lower payroll tax receipts because fewer taxpayers are employed. Second, without jobs, residents change their consumption behavior, including items that are subject to taxation. Declines in consumption directly result in lower sales and use tax receipts. In Michigan, both income and sales taxes finance public education.

Changes in wage and salary employment are reflected in the personal income generated in the state. The metric of personal income, which includes wages and salaries, captures the overall health of a state's economy. **Chart 7** presents Michigan income over the entire period in nominal and real (inflation adjusted or constant 2010 dollars) terms. The three sub-periods (1995 to 2000, 2001 to 2007, and 2008 to present) are delineated by the change in the direction and/or slope of the respective line in the chart. Through 2000, both real and nominal personal income saw positive annual changes. Beginning in 2001 and extending through 2007, growth in actual income slowed while real income stagnated, basically exhibiting flat growth During the most recent period, both actual and real income levels experienced annual declines.

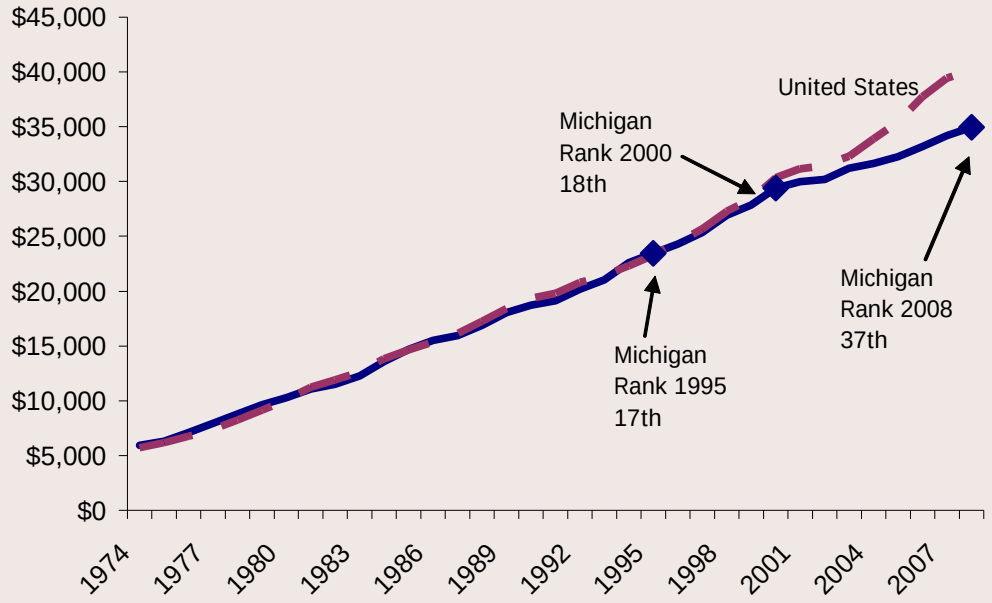
Average per-capita personal income is a useful metric for comparisons among states or with the nation

Chart 7
Michigan Personal Income: 1995 to 2010
Real and Nominal



Source: U.S. Department of Commerce; May 2010 Consensus Revenue Estimate

Chart 8
Michigan and U.S. Per Capita Personal Income: 1974 to 2008



Source: U.S. Department of Commerce

as a whole. Michigan's position relative the U.S. average is shown in **Chart 8**. This 35-year period includes Michigan's experience under the current education finance system created by Proposal A as well as the finance system that preceded it.

Following the adoption of Proposal A in 1994, Michigan's per-capita income national rank was 17th, which was minimally above the national average. Over the next five years the state's position slipped marginally to 18th among the 50 states; by 2000, Michigan's per-capita income was three percent below the U.S. figure. Since that time, a growing gap has developed between Michigan and U.S. per capita personal income, causing Michigan's position to drop to 37th in 2008. Michigan went from being a state in the top one-third in terms of individual wealth in 1995, following the adoption of the current school finance system, to one that is in the bottom fourth of all states. Michigan's per-capita personal income in 2008 is 13 percent below the national average figure and the state's ranking is expected to fall further in response to the 2008 recession.

Absent significant changes to the bases or rates of major taxes in Michigan, the new ranking is going to require a "re-calibration" of public service levels.

The implications of Michigan's slide relative to the nation are significant. First, after being a relatively "wealthy" state for most of the last 35 years, Michigan now finds itself a relatively "poor" state. Second, Michigan's current status is likely to represent a new reality rather than a temporary condition. To regain its previous ranking will require the Michigan economy to expand at a significantly faster rate than the rest of the U.S. Coupled with the effects of the recent recession, Michigan's current status most likely represents a new normal or baseline. Third, Michigan's lower per-capita figure suggests that residents' "ability to pay" for public services through taxes is diminished. Absent significant changes to the bases or rates of major taxes in Michigan, the new ranking is going to require a "re-calibration" of public service levels.

The changes observed in Michigan's economic performance between 2000 and 2008 are largely foundational as opposed to cyclical. A massive shift away from manufacturing, which had been building for years, accelerated during the early years of the new century and effectively transformed the underlying economic base upon which state taxes depend. At the same time, the state was not immune from the effects of two national recessions since 2000, the most recent one considered to be the longest and most severe in 70-plus years. The combined economic effects of the structural changes and the two recessions on Michigan's economy have been profound. For Michigan's public education finance system, economic activity is the primary determinant of overall revenue levels since the turn of the century.

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State Revenue Performance

For the purposes of this report, state on-going resources available to schools include dedicated major taxes (sales/use, income, and property) as well as minor taxes (alcohol, tobacco, and others), annual transfers from the General Fund, and lottery proceeds deposited in the School Aid Fund (SAF). On-going revenues do not include federal resources, which state policy makers have little discretion over, or those non-recurring state resources that have been provided from time-to-time to augment permanent funding. Since the adoption of the school finance reforms, total state-source, on-going SAF revenues grew from $7.7 billion to $11.5 billion, an increase of 51 percent, from FY1995 to FY2008. This amounts to an average annual rate of change of 3.2 percent, above the 2.5 percent annual rate of change in the U.S. CPI over the same period. The aggregate revenue growth is influenced by a host of factors including, the performance of the underlying economy, changes in tax rates, changes in tax bases, and the addition of new taxes earmarked to finance schools.

In relation to broad measures of overall economic activity during this period, SAF revenues grew at a pace slightly below the average annual growth rate of Michigan personal income (3.4 percent). As was the case with total school operating revenues, when SAF revenue growth is viewed over the entire 13-year period at a macro level, it appears to have fared relatively well. However, this picture changes when the component pieces of the Fund are dissected and the larger period is broken into constituent parts and the various forces at work during each sub-period are examined.

Table 6 looks at individual SAF revenues and their annualized growth rates over the entire period and over two distinct periods, compared to inflation and economic growth. [Note: FY1997 was the first full year of the current income tax earmarking provision and therefore is selected as the starting point for comparisons rather than FY1995, the first year of Proposal A's implementation.] The selection of FY2001 as the "break point" to divide the two sub-periods is not arbitrary, but based upon the performance of Michigan's economy, before and after this point. The robust economic growth that characterized Michigan during the mid- to late-1990s subsided by the start of FY2001 with the onset of a short, national recession. Because the underlying state economic activity upon which SAF revenues are based was very different for these two periods, it is appropriate to examine the two periods separately. A discussion of more recent revenue performance (FY2009 to today) follows a review of the first two sub-periods.

Table 6
School Aid Fund Revenue Annualized Growth Rates: FY1997 to FY2008

Revenues	FY1997 to FY2000	FY2001 to FY2008	FY1997 to FY2008
State Taxes	6.2%	2.0%	3.1%
Lottery Transfer	1.7%	3.4%	2.1%
General Fund Transfer	4.6%	-31.6%	-18.5%
Total State School Aid Fund Revenue	5.9%	1.5%	2.7%
Michigan Personal Income	5.6%	2.2%	3.1%
U.S. CPI	2.2%	2.8%	2.7%

Source: Michigan Department of Education

Table 7
State Tax Revenue Annualized Growth Rates: FY1997 to FY2008

Revenues	FY1997 to FY2000	FY2001 to FY2008	FY1997 to FY2008
Sales / Use Tax	5.4%	0.9%	2.1%
State Education Tax	6.1%	4.9%	5.5%
Income Tax	7.5%	1.1%	2.7%
Subtotal Major Taxes	**6.0%**	**1.7%**	**2.9%**
Tobacco Taxes	3.4%	1.5%	1.8%
Real Estate Transfer Tax	10.1%	-5.5%	-1.1%
Michigan Business Tax*	NA	NA	NA
Other**	16.8%	0.1%	4.6%
Total Taxes**	**6.2%**	**2.0%**	**3.1%**
Michigan Personal Income	5.6%	2.2%	3.1%
U.S. CPI	2.2%	2.8%	2.7%

* Earmarking of a portion of Michigan Business Tax began in FY2008, so annual growth rate unavailable; however, amounts of this tax are included in collections for FY2008.

** No adjustment for restructuring of state business taxes, which affected collections of the State Education Tax, Michigan Business Tax, and Other categories beginning in FY2008.

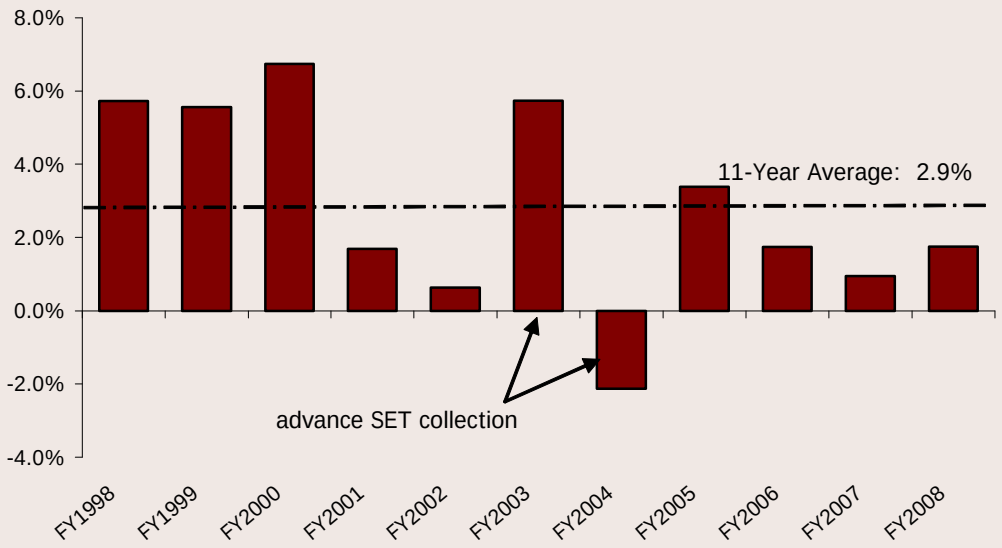
Source: Michigan Department of Education

Revenue Growth of SAF Taxes: FY1997 to FY2008

The bulk of the state tax revenues dedicated to finance education in Michigan come from three major sources: consumption, property, and individual income taxes. These represent the major on-going resources for public education, while other smaller amounts have contributed to the SAF to varying degrees over the years. On average, these three taxes collectively account for $9 of every $10 in total state taxes going to the SAF each year. Given their importance to the overall level of on-going state revenue available each year, specific attention is directed at how these taxes have performed over the period FY1997 to FY2008 (See **Table 7**).

Chart 9 depicts, in the aggregate, year-over-year changes in the major SAF tax collections and shows the two distinct periods, pre- and post-FY2001. Over the entire period, SAF receipts from the major taxes grew 36 percent in the aggregate, or at an annualized rate of 2.9 percent. Through FY2000, however, the average annual growth rate was slightly more than double (6 percent), before slowing considerably for the remainder of the period. Receipts from the major taxes grew 1.7 percent per year from FY2001 to FY2008. Largely as a result of advancing the collection of the 6-mill State Education Tax (SET), major tax receipts grew nearly 6 percent year-over-year in FY2003 and subsequently declined 2 percent in FY2004.[10] When revenue growth is examined over the period FY2001 through FY2008, the one-time nature of the SET collection date change does not influence the annualized growth rate computed for the entire period, but it does materially affect the rates observed for two years. These intra-period annual rates are of less concern in this analysis as the focus here is the long-term growth of on-going major tax sources. It is worth noting that only one year after FY2001 (FY2005) exhibited a year-over-year increase that exceeded the annualized growth rate for the entire 11-year period (ignoring the one-time effects of the SET changes).

Chart 9
Year-Over-Year Change in Total Major* SAF Tax Revenue: FY1998 to FY2008



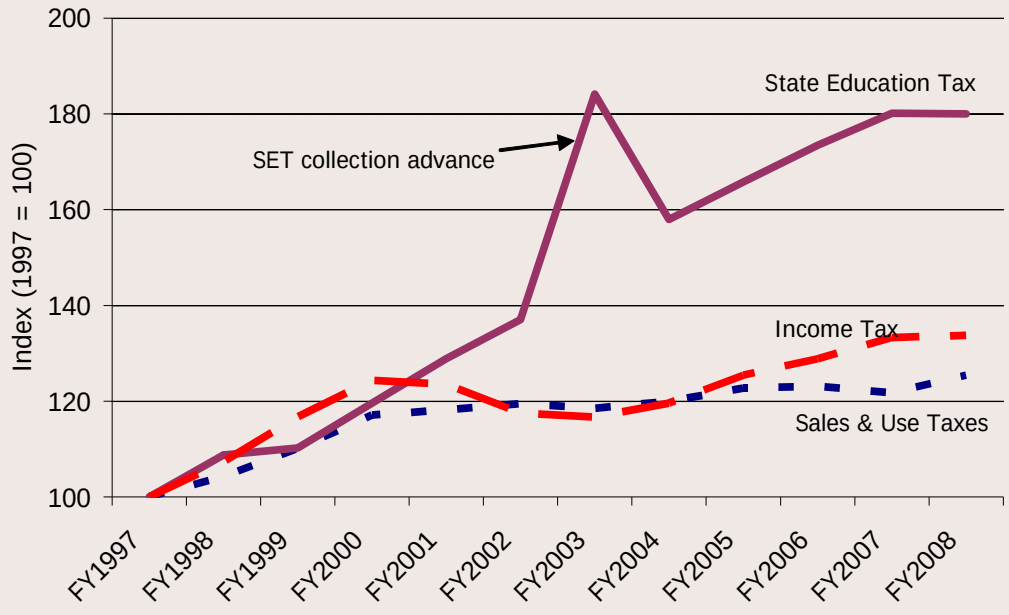
* Sales/Use, Income, State Education Tax

Source: Michigan Department of Education

Chart 10 illustrates the growth (index: FY1997 = 100) of the three major SAF taxes individually to show differences in their performances. Through FY2000, the performance of the individual taxes mirrored one another for the most part, showing consistent robust annual growth. Beginning in FY2001 and continuing through FY2008, the growth patterns of the consumption and income taxes look similar to each other, but very different from the growth in the 6-mill SET, which showed uninterrupted stable growth. The average annual growth rate of the SET was 5.5 percent over the entire period, compared to 2.1 percent for the sales and use taxes and 2.7 percent for the income tax. Receipts from the SET, again ignoring advance collections in FY2003, were buoyed by the relative stability that accompanies the property tax in general as well as a healthy real estate market that boosted property values in Michigan over the period.

Consumption tax and income tax receipts were relatively stable in the post-FY2000 period. Both taxes exhibited at least one episode of year-over-year declines, with SAF-dedicated income tax revenues showing declines in three consecutive years (FY2001 through FY2003). During this period, while total income tax receipts were negatively affected by the tax rate reductions enacted, the fiscal effects of the tax policy changes were entirely borne by the state's General Fund and the School Aid Fund allocation was shielded. Absent major tax policy changes during the FY2001 to FY2003 period affecting SAF taxes, the income tax and consumption tax revenue declines observed in the early 2000s were attributable mainly to the onset of the 2000-2001 national recession.

Chart 10
Growth of Major SAF-Dedicated Taxes: FY1997 through FY2008



Source: Michigan Department of Education

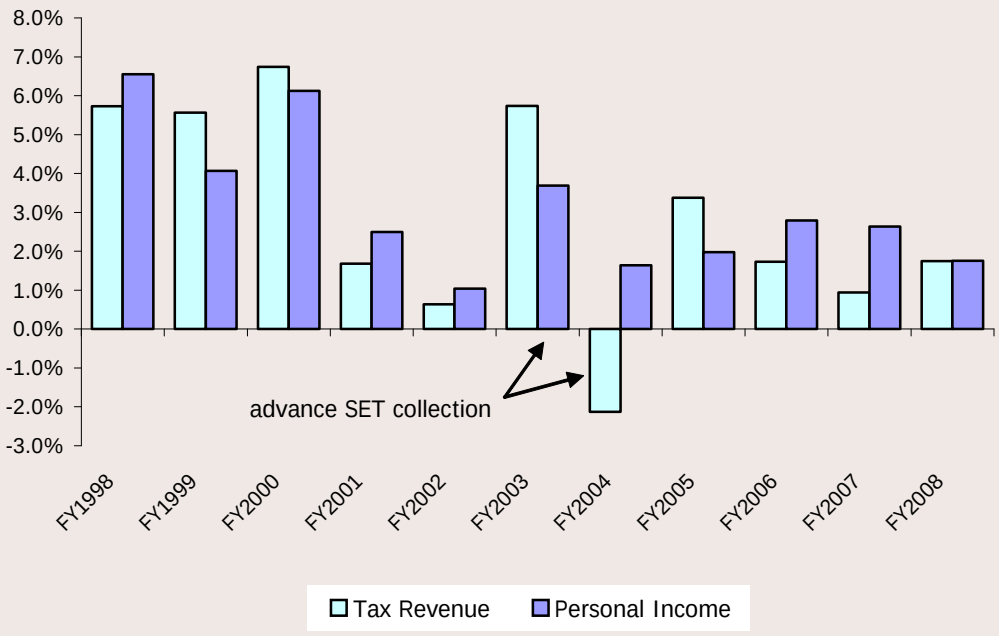
Changes in annual tax receipts, in the aggregate, generally paralleled the changes observed in the broader economy, as measured by Michigan personal income (See **Chart 11**) throughout the period. The degree of annual change, however, varies over the two different periods. Through FY2000, annual increases in tax revenue receipts generally met or exceeded changes in economic activity in the state. Both economic growth and annual changes in tax receipts eclipsed the four percent level each year. The national recession and its effects on tax receipts became evident in FY2001, when annual growth rates are halved. Following the FY2001 decline, Michigan's sustained economic malaise was further evidenced in the personal income annual growth rates between 2002 and 2008, which averaged 2.2 percent.

Other State Taxes

In addition to the major SAF taxes, state education revenues available each year also depends on the performance of minor state taxes earmarked to the SAF, which account for 10 percent of the total tax picture. These minor taxes consist of all or a portion of the receipts from the following taxes: liquor excise, cigarette, other tobacco, real estate transfer, Michigan business, industrial facilities, casino, commercial forest, and other special taxes. Of these, tobacco taxes make up about half (4.5 percent of the total) of all other SAF taxes. In the aggregate, the non-major SAF taxes have performed better than the major taxes, but their relatively small share of total revenues inhibits their ability to affect materially the overall growth rate of total SAF revenues.

Revenues from this group of taxes increased from $700 million to $1.2 billion (70 percent) from FY1997 to FY2008, which translates to an average annual growth rate of 5.0 percent. This was almost twice the growth in the inflation rate during the same period and exceeded the annualized growth rate in Michigan personal income. The annualized growth

Chart 11
Year-Over-Year Change in Major SAF Tax Revenue and Personal Income: FY1998 to FY2008



Source: Michigan Department of Education; U.S. Department of Commerce

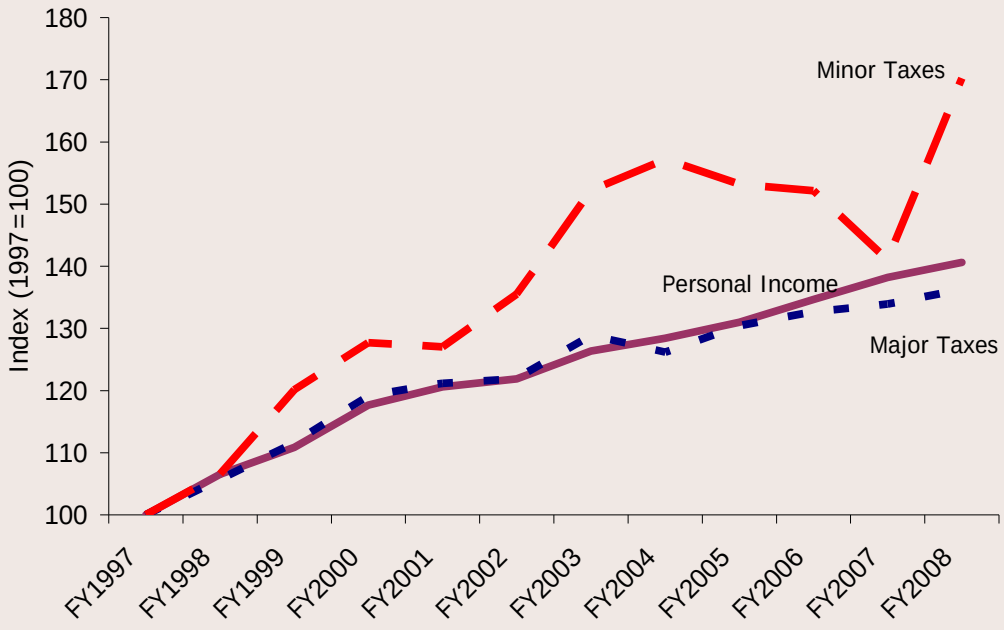
rate for these taxes as a group, at least measured against the economy and inflation, is somewhat misleading as it benefited from two important tax policy changes, both of which impacted the disposition of Michigan Business Tax (MBT) receipts to the SAF beginning in FY2008 (discussed below).

Comparing the growth of SAF major and minor taxes to changes in Michigan personal income reveals that receipts from the smaller taxes did not grow in concert with state economic activity (**Chart 12).** Minor taxes, as a group, exhibited the greatest amount of volatility between FY2005 and FY2008. After declining for three consecutive years in a row, a spike in revenue receipts occurred in FY2008 as a result of major state business tax policy changes (discussed below).

Over the entire period, growth of the minor SAF taxes was fueled by a number of factors different from those which affected major tax receipts. Of particular note, minor tax growth benefited from a number of tax rate increases and the adoption of new taxes, factors which did not contribute to the performance of the major SAF taxes since Proposal A. A series of tobacco tax increases in 2002 and 2004 were largely responsible for buoying the growth trend between FY2002 and FY2004, at least for this declining revenue source. Beginning in FY2004, tobacco tax receipts have declined each year along with collections from the industrial facilities and real estate transfer taxes, contributing to the subsequent decline in SAF receipts. Tobacco tax receipts have declined, on average, 3.5 percent annually since FY2004, indicative of the steady, long-term decline in tobacco use.

Significant changes in Michigan's business tax system, combined with new tax earmarking provisions, contributed to the FY2008 revenue spike. The series of changes affected school financing in markedly different ways. The first change did not affect

Chart 12
Growth of SAF-Dedicated Major and Minor Taxes and Personal Income: FY1997 through FY2008



Source: Michigan Department of Education; U.S. Department of Commerce

the amount of education resources, but it did change the "state" / "local" revenue mix - state tax revenues replaced local tax revenues on a dollar-for-dollar basis. The second tax policy change responsible for the growth in minor tax growth in FY2008 involved a tax increase.

Regarding the shift from local to state resources, as part of the state's efforts to modify the business tax climate, numerous personal property tax exemptions were enacted that negatively affected state and local school tax revenues. To safeguard education from these reductions, a new revenue earmark of the MBT was enacted. The tax policy changes involved sizeable shifts in revenue-raising responsibility from the local to the state level but had no net impact on overall education finances. (See Tax Restructuring box.) The business tax re-write reduced local education funds by $342 million (full-year basis) and increased SAF revenues by an equal amount, thereby contributing to the sharp up-tick in minor tax receipts observed in FY2008 and to the strong growth rate for this category over the entire FY1997 to FY2008 period. The earmark of MBT revenue to the SAF also accounts for the exemptions of industrial personal property from the State Education Tax and the Industrial Facility Tax.

The amount of the MBT earmark to the School Aid Fund was expanded when the MBT surcharge was adopted (Public Act 145 of 2007). This changed effectively replaced, dollar-for-dollar, the tax revenues that would be collected under the new services tax (Public Act 93 of 2007). The law to expand the Use Tax base to services was repealed before taking effect on December 1, 2007. To hold schools harmless from the tax policy changes, the amount of the projected revenues ($250 million on a full-year basis) was added to the existing MBT earmark. These resources represented new, additional funds for public education in Michigan.

Business Tax Restructuring Effects on School Finances

As part of Michigan's broad business tax restructuring efforts in 2007, certain personal property was exempted from state and local property taxes dedicated to finance education services. In order to protect schools from the revenue losses associated with the property tax changes, a portion of the annual revenues derived from the newly-created Michigan Business Tax (MBT) were dedicated to the School Aid Fund, beginning in FY2008. The changes were designed to provide property tax relief to Michigan-based businesses without harming local school finances.

Tax law changes, effective for the 2008 tax year, exempted industrial personal property from the 18-mill local school operating tax, the 6-mill SET, and the portion of the Plant Industrial Facility Tax (PA 198 of 1974) attributable to the SET and local school operating taxes.[i] As a result of these changes, all industrial personal property in Michigan is exempt from school operating property taxes (state and local). Commercial personal property also is now exempt from 12 mills of the required 18-mill local operating tax. Commercial personal property did not receive the exemption from the SET that industrial property received. Combined, these changes were estimated to reduce state and local property tax revenues dedicated to finance education by $479 million on a full-year basis (FY2009 estimate). A fixed-amount statutory earmark of Michigan Business Tax revenue was designated to the School Aid Fund to hold schools harmless from these changes in FY2008 and FY2009, with the amount increasing with inflation beginning in FY2010 and beyond.

Subsequent tax policy changes increased the level of MBT revenues earmarked to the SAF. These revenues were intended to offset the loss of use tax revenues dedicated to the SAF resulting from the repeal of a 2007 law that expanded the base of the tax to include certain services. The additional SAF revenues were available from the creation of a tax surcharge to be applied to taxpayers' MBT tax liability. The SAF earmark was increased to $729 million for FY2009, with this amount set in statute to grow with inflation beginning in FY2010. The increase in the earmark, $250 million in FY2009, represented new, additional money provided to schools. Further changes in Michigan's tax law effectively reduced the SAF earmark of MBT revenue by an amount exactly equal to the SAF's share of use tax collections on Medicaid managed care organizations (PA 440 of 2008), estimated at $112 million in FY2009.

The aggregate fiscal impact of the business tax changes and the associated earmarking provisions was intended to be revenue neutral for schools. Beyond this universal policy objective of the business tax changes, the modifications also had two other notable repercussions on school finances. First, the elimination of local property tax revenues and their replacement with an equal amount of state tax revenues represented further "centralization" of Michigan's education revenues. The respective shares of the overall financing responsibility were altered with the "state" component increasing and the "local" piece declining.

The second notable implication for school finances relates to the fixed nature of the MBT earmark to the School Aid Fund and its indexed growth factor. This provision in the business tax policy changes of 2007 is expected to provide additional stability to K-12 revenue, both in the short term as well as over the long run. In the short-run, indexing MBT revenue growth to the inflation rate rather than tying school revenues to economic activity shields school finances from the inherent volatility that accompanies MBT receipts. (Note: The MBT consists of a both a business income tax and modified-gross receipts tax.) In much the same way that the state's General Fund shouldered the full effects of the phased-in individual income tax rate reductions as a result of the earmarking provisions, the General Fund will experience the full effects of MBT revenue volatility while schools are protected. For example, General Fund MBT deposits are expected to decline 26 percent in FY2010 in response to the economy, but the SAF earmark will fall less than one-half of one percent. Over the longer-term, the indexing provision is likely to cause school revenues to increase faster than they would have if industrial personal property was still part of the state and local property tax bases. Changes in the inflation rate are likely to increase faster, at least in the long-term, than the annual growth in personal property tax receipts.

Overall, the 2007 tax policy changes that restructured Michigan's business taxes further centralized education finances at the state level, at least for K-12 districts; shielded annual school revenues from economic volatility affecting state tax receipts; and enhanced long-term stability of SAF revenue growth.

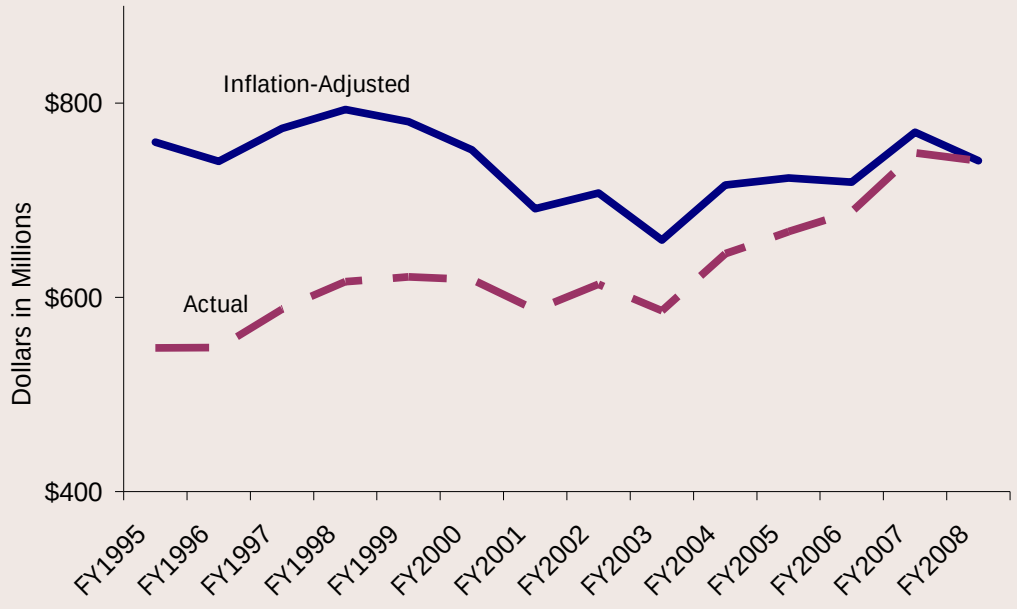
[i] Public Acts 37 to 39 of 2007.

Other On-going State Revenues: Lottery and General Fund

Lottery profits have consistently accounted for about 6 percent of the total state-source School Aid Fund revenues since Proposal A, although the specific amount has varied from year-to-year. Despite the popular misconception that the lottery contributes significantly to the funding of public education in Michigan, it actually amounts to a relatively small piece of the state contribution and an even smaller component when local operating revenues are incorporated and the entire funding picture is considered. Net lottery revenues contributed $741 million to school operational funding in FY2008. These statutorily-dedicated revenues have grown at an average annual rate of 2.3 percent, about equal to inflation from FY1995 to FY2008. This average rate, however, hides considerable year-to-year variation, as reflected in **Chart 13**. In recent years, inflation-adjusted lottery receipts have increased modestly; however, the inflation-adjusted FY2008 amount remains below the FY1995 level following a number of years of flat or negative growth.

Unlike the annual growth of major SAF taxes, lottery proceeds do not mirror changes in Michigan economic activity as measured by personal income. Year-over-year lottery sales increases (and therefore profits) tend to occur with the introduction of new games.[11] In recognition of this, the State of Michigan continuously introduces new gaming opportunities to maintain interest and sales. Since Proposal A's adoption, lottery games have experienced significant growth in competition for discretionary gaming dollars in Michigan. Today there are 19 Native American casinos in operation along with three Detroit casinos. This compares with eight Native American gaming establishments when Proposal A was adopted. Despite this considerable competition, lottery profits have been able to maintain modest annual growth since FY2004.

Chart 13
SAF Lottery Revenues: Actual and Inflation-Adjusted (FY2008 Dollars): FY1995 through FY2008



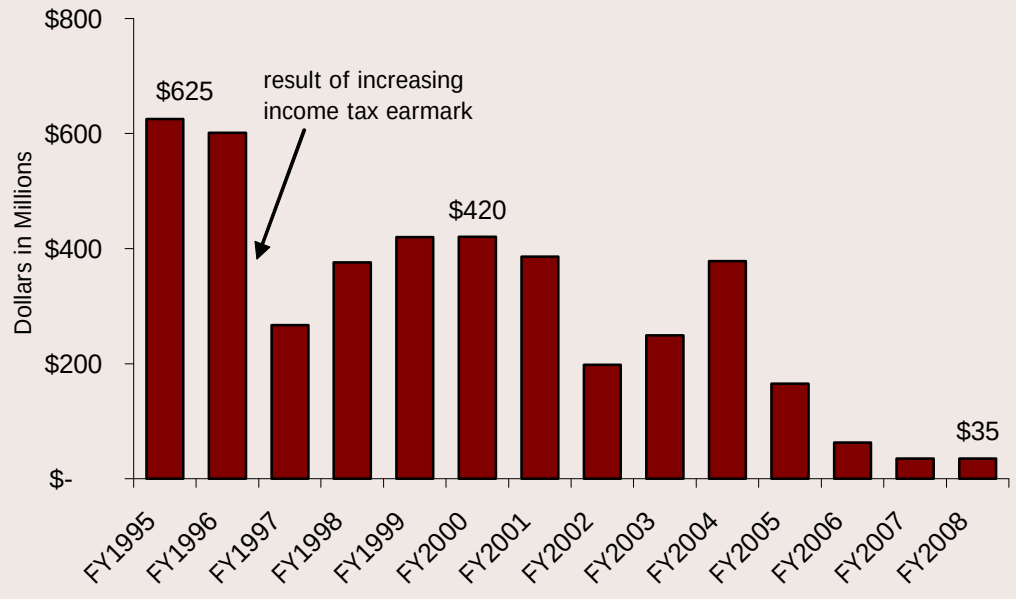
Source: Michigan Department of Education; U.S. Department of Commerce

In FY 1997, the amount of income tax revenues earmarked to the School Aid Fund was increased, and this increase was accompanied by an equal reduction in the amount transferred from the General Fund that year in order to hold the SAF harmless. Following the enactment of the income tax earmark, the General Fund transfer increased each year, peaking at $420 million in FY2000. The General Fund transfer has subsequently been reduced and is now approximately $35 million.

Historically, the annual allocation from the state's General Fund was intended to serve multiple objectives. First, a portion of the resources was used to pay certain education-related costs assignable to the General Fund, which for budgetary reasons are included in the annual SAF budget.[12] Second, General Fund dollars transferred to the SAF reflected the priority that state elected officials placed on public education vis-à-vis other competing programs. Thus, changes in total state education support were not determined solely by the changes in earmarked taxes. Third, continuation of the annual General Fund grant in the post-Proposal A period suggested that dedicated state taxes are not sufficient to support schools.

Beginning in the early 2000s, a general budgetary shift occurred with respect to the amount of the General Fund contribution to the SAF. Over the intervening years, the amount of General Fund resources transferred to the SAF was reduced, to the extent that the General Fund now does very little to supplement dedicated state education revenues (See **Chart 14**). The reduction of General Fund support to the SAF over the past nine years is a direct product of the on-going fiscal challenges facing the General Fund budget (see General Fund Budget Challenges).

Chart 14
General Fund Allocations to School Aid Fund: FY1995 through FY2008



Source: Michigan Department of Education

Other Non-recurring State Resources

From time to time since Proposal A, School Aid Fund expenditures have been financed by state resources other than earmarked taxes, lottery proceeds, and the annual contribution from the General Fund. In some years, non-recurring state resources have been used to supplement on-going resources to help maintain spending levels, especially the per-pupil foundation grant. This practice was employed as a response to the reduction in dedicated SAF taxes resulting from the 2000-2001 recession. In other years, the extraordinary resources were used to finance new state public education obligations resulting from the Michigan Supreme Court's *Durant* decision in 1997. The use of these non-recurring resources has been excluded from the discussion regarding state revenue performance because they were always intended to represent one-time monies, rather than on-going resources, and their inclusion here would distort the picture of school finance being presented in this analysis.

Few sources of non-recurring funds have been used to support operational expenditures of the SAF, although when these funds have been provided the amounts have been significant. In FY2003, state debt (School Bond Loan Fund) restructuring provided an additional $131 million in one-time SAF revenues. State of Michigan reserves have been used too, including the transfer of $350 million from the Economic and Budget Stabilization Fund, the state's rainy day fund, in FY2002. This transfer was used to support SAF spending in both FY2002 and FY2003 and help manage through the economic downturn of the period, primarily with the goal of preserving the per-pupil foundation allowance. While the transfer shielded the per-pupil grant from a statutorily-required prorated reduction in FY2002, it was insufficient to avoid such reductions in FY2003 and FY2004. (Those reductions equated to $74 per student.)

In June 1997, the Michigan Supreme Court issued its decision on the long-standing case, *Durant et. al., v State of Michigan*. At issue was an unfunded mandate claim made by plaintiff school districts against the State of Michigan pursuant to Article IX, Section 29 of the Michigan Constitution. Specifically, the school districts in the case challenged the level of state support for special education services provided at the local level. The schools prevailed in the case, and the Supreme Court provided a financial settlement to the schools. The State of Michigan also negotiated a financial settlement to school districts not directly plaintiffs in the *Durant* case and therefore not eligible to receive a portion of the payment ordered by the Supreme Court. As a matter of fairness, the state sought a financial solution for both plaintiffs and non-plaintiffs, but the specifics for each group differed.

Payments were structured in a number of ways, including lump-sum and annual, depending whether a school was a "plaintiff" or a "non-plaintiff" district. To finance some of the required payments, the School Aid Fund received a series of annual transfers, of various amounts, from the state's rainy day fund from FY1998 to FY2003. Unlike the $350 million transfer in FY2002 to support current school operations, the rainy day fund transfers associated with the *Durant* decision were used to pay for damages incurred by local school districts as a result of past under-funding by the State of Michigan and were not intended to support on-going expenditures at the local level. [Note: A lump sum payment totaling $212 million in FY1998 to "plaintiff" districts did not include restrictions on the use of the funds. "Non-plaintiff" districts received a series of annual payments beginning in FY1999; however, unlike the payments to the "plaintiff" districts, the state placed restrictions on the use and timing of the payments received by "non-plaintiffs".] According to the Senate Fiscal Agency, a total of $414 million from the state's rainy day fund was transferred to the SAF to finance the various provisions of the *Durant* decision from FY1998 to FY2003.

The use of these non-recurring resources, particularly with respect to on-going SAF expenditures, allowed education spending to increase at a faster rate than the on-going earmarked SAF taxes when the economy slowed. No doubt, these resources were critical pieces to the overall school finance picture when they were employed; however, they do not represent monies that are available over the long-term. Including them in the discussion and figures presented in this report would result in a picture of school revenues (both annual levels and growth rates) that is artificially high.

General Fund Budget Challenges

The State of Michigan has a long history of supporting public education with General Fund resources. These resources always played the minority role in the context of the state's overall funding responsibility, with the SAF-dedicated revenues playing the majority role. Despite this minority role, the level of General Fund dollars going to support education each year has never been immune to the challenges faced by the state's General Fund budget. This reality existed prior to the Proposal A reforms and remains true today.

General Fund support of public education cannot be examined in isolation but must be understood in the context of the state's competing needs and obligations. Earmarking provisions and other budgetary practices segregate the General and School Aid Fund budgets in theory; ultimately, however, annual appropriation decisions involving these two major funds are made simultaneously by policy makers. Each year, policy makers face seemingly infinite competing demands for finite state resources, and as a general rule, the entirety of the state budget is under consideration at the same time in the development of the annual state spending plan.

This brief summary provides a backdrop against which state education funding provided through the SAF has operated during the eight-year period, FY2000 to FY2008.

- Total General Fund revenues dropped by $471 million, or 4.8 percent, from FY2000 to FY2008.
- Over the period of FY2000 to FY2003, on-going General Fund tax receipts declined by $1.8 billion (19.2 percent).
- Adjusted for inflation, total General Fund revenues declined by $2.6 billion (21.7 percent) and tax receipts dropped by $2.5 billion (21.6 percent) between FY2000 and FY2008.
- Individual income tax receipts (largest revenue source) remained unchanged, despite a rate increase (3.9 percent to 4.35 percent) effective for FY2008.
- Single business tax receipts (second largest source) declined $507 million (21.8 percent) from FY2000 to FY2007

The on-going revenue challenges of the first half of the decade resulted from the economic decline associated with the 2001 recession as well as aggressive cuts in the personal income and single business tax rates. Other tax policy actions that contributed to the rapid decline in General Fund revenues between FY2000 and FY2003, included tax base reductions in the personal income, sales, and single business taxes.

As the economy and tax policy changes reduced General Fund revenues, state policy makers struggled to maintain required budget balance. General Fund spending was reduced, but not at the same rate as on-going revenues. To support this end, on-going spending in the General Fund was supplemented with nearly $6 billion in one-time resources between FY2000 and FY2006.[1] The heavy use of one-time resources initially reflected the lag in adopting permanent expenditure reductions, but later became a key component of the annual budget balancing equation as revenues continued their decline.

Despite severe struggles to achieve budget balance in previous years, the fiscal challenges facing the General Fund reached a public crescendo in the early fall of 2007. Facing an estimated $1.8 billion shortfall in FY2008, state government was temporarily shut down on October 1, 2008, when the requisite state appropriations were not passed by the start of the new fiscal year. The FY2008 budget was balanced with $1.1 billion in increased tax revenues.

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[i] Citizens Research Council of Michigan. *State Budget "Balance" for FY2007 Achieved with $1 Billion in Additional Non-Re*curring Resources. State Budget Note. June 2007.

Cost-Shifting Items to the SAF Budget.

Another policy shift affecting the SAF and the General Fund has occurred in recent years. This shift does not appear in the figures presented in **Chart 14**, although its effect on annual state education revenues is the same as the decrease in the General Fund contribution to the SAF. Beginning in the mid- 2000s, a series of program transfers have been made that effectively required the SAF to pick up the financing costs of programs previously financed by other state dollars, most often General Fund resources. These programs were previously administered by other state agencies and funded in their respective budgets and subsequently transferred to the annual School Aid Fund budget via annual budget decisions. Nearly all of these transfers were made to address General Fund budget shortfalls. While the appropriateness of each item transferred to the SAF can be debated, the bottom line is that these budget decisions have resulted in more demands being placed on the finite annual resources available in the SAF.

The House Fiscal Agency reports that the FY2010 costs of the transferred programs total $209 million.[i] One of the largest transfers is the cost of borrowing to meet SAF cash flow needs (e.g., mainly associated with the receipt of state tax revenues and the timing of payments to schools).[ii] Beginning in FY2007 and again in FY2008, a portion ($22.8 million each year) of the total cost was shifted back to the SAF and by FY2009, this amount doubled to $45 million. The State of Michigan issued short-term debt in FY2003 through FY2006 to meet its cash needs, including those of SAF; however, in those years the General Fund covered all of the borrowing costs.

Other major items where financing responsibility has been transferred to the School Aid Fund include: *Durant* settlement debt financing ($39 million), School Bond Loan Redemption ($40 million), and reimbursement to renaissance zones ($26 milion).

Annual legislative determinations, primarily driven by shortfalls in the General Fund budget, have resulted in reduced annual General Fund transfers to the SAF. These direct reductions in state support for education have been exacerbated by a steady increase in the new costs that the SAF must pick up.

[i] House Fiscal Agency, *School Aid Programs Formerly Funded from GF/GP or BSF and Department Transfers*, unpublished, October 2009.

[ii] In recent years, the State of Michigan has been issuing short-term debt to finance, in part, its combined major fund (General and School Aid Fund) cash needs throughout the year. This borrowing is permitted under Article IX, Section 14 of the Michigan Constitution. This external borrowing occurs in addition to the internal borrowing within the state's Common Cash Fund in order to meet the state's cash obligations throughout the year. Because of the incongruence between the timing of tax receipts and monthly School Aid Fund payments, the Fund is required to borrow from both internal and external sources to meet its obligations. A more complete discussion of the state's cash flow borrowing experience can be found in the CRC publication, *Michigan's Deteriorating Cash Position*, Note 2007-2, May 2007.

Revenue Performance over the 2008 Recession

The 2008 recession that officially began in December 2007 has adversely affected the growth of all state taxes through FY2009.[13] The fiscal effects of the "Great Recession" are expected to continue in FY2010 with lingering effects into FY2011. For many observers of State of Michigan finances, most notably local and intermediate school districts and their constituents, the substantial declines in state education revenues became a flashpoint issue because of the budget reductions that accompanied the sharp drop in state revenues in FY2009 and the moderate decline that is currently projected for FY2010. The magnitude of the annual reductions in on-going state revenues in FY2009 had not been seen in the post-Proposal A era, indicating that the school finance system has entered uncharted waters.

Michigan's weak revenue growth from FY2001 to FY2008 is attributable to the mild 2001 recession and economic restructuring in Michigan. In contrast, the revenue performance for FY2009 and FY2010 is attributable to forces occurring outside of the state, the product of a very severe national recession. Given the recession's severity, the annual changes in FY2009 and FY2010 are not viewed as an indication of the start of a long-term trend. Current official FY2011 revenue estimates (combined General and School Aid Funds) project a reversal of the annual changes observed for the previous two years and a modest increase (2.8 percent) in baseline rev-

enue growth. "Baseline" revenues reflect receipts before the incorporation of tax and budgetary adjustments and reflect the revenues resulting from underlying economic activity.

Although the annual FY2009 and FY2010 revenue growth rates are not indicative of a long-term trend, they will have the effect of "re-setting" state revenues, for both the General and School Aid Funds, at markedly lower levels. In the years to come, the Great Recession will have established a new base level from which state revenues will grow going forward. Because of the temporary nature of the most recent economic downturn and the steep annual declines in state revenue, it is instructive to examine state revenue performance since FY2001 in two distinct periods, FY2001 to FY2008 and afterwards.

Table 8 tracks state education revenues from FY2001 to FY2008 compared to FY2009 actual figures and current estimates for FY2010.[14] The relatively weak annual growth rates observed over the earlier eight-year period stand in stark contrast to the yearly changes in FY2009 and projected for FY2010, when both years show outright revenue declines. [Note: The data presented are adjusted to account for the personal property tax exemptions associated with the business tax changes effective 2008 and affecting MBT deposits to the SAF in FY2008 and beyond. These adjustments to the data are necessary in order to compare across the two periods because they artificially increased state revenues and reduced local revenues by an equal amount.] The declines in state funds over this two-year period were partially offset by the availability of non-recurring federal funds from the stimulus (See *American Recovery and Reinvestment act of 2009* on p. 37).

Table 8
State School Aid Revenue Changes: FY2001 to FY2010
(Dollars in Millions)

	FY2001	FY2008	Average annual growth rate	FY2009	Annual change	FY2010	Annual change
Sales / Use Tax	$5,075.9	$5,387.4	0.9%	$4,793.2	-11.0%	$4,865.7	1.5%
Income Tax	1,955.3	2,117.7	1.1%	1,895.3	-10.5%	1,815.3	-4.2%
State Education Tax	1,489.6	2,079.7	4.9%	2,040.6	-1.9%	1,893.0	-7.2%
Michigan Business Tax*	NA	205.0	NA	250.0		250.0	
Real Estate Transfer Tax	252.9	169.8	-5.5%	125.3	-26.2%	127.0	1.4%
Tobacco Taxes	383.1	424.7	1.5%	410.4	-3.4%	387.3	-5.6%
Liquor Taxes	28.4	36.9	3.8%	37.6	1.9%	38.2	1.6%
Industrial Facilities Tax	131.3	86.1	-5.8%	41.8	-51.5%	47.8	14.4%
Casino Gaming Tax	75.4	112.1	5.8%	108.1	-3.6%	109.6	1.4%
Other	15.2	17.1	1.7%	16.3	-4.7%	16.2	-0.6%
Total Taxes	9,407.1	10,636.5	1.8%	9,718.6	-8.6%	9,550.1	-1.7%
Lottery Proceeds	587.0	740.7	3.4%	724.5	-2.2%	723.0	-0.2%
Total State Revenues	9,994.1	11,377.2	1.9%	10,443.1	-8.2%	10,273.1	-1.6%

* FY2008, FY2009, and FY2010 figures are adjusted to account for the personal property tax exemptions included in the business tax changes effective 2008. Figures exclude MBT revenue designed to replace, dollar-for-dollar, lost local personal property tax revenues effective 2008.

Source: FY2001 through FY2008, Michigan Department of Treasury; FY2009 and FY2010, Consensus Revenue Estimates as of May 2010 (adjusted by CRC).

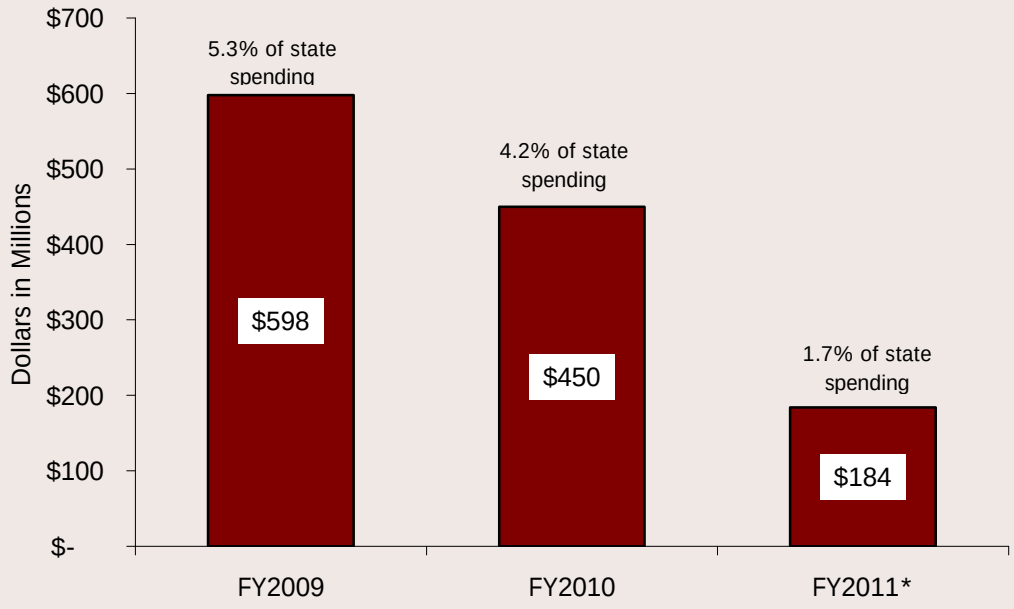
From FY2008 to FY2009:

- All state education revenues declined from their previous year levels, with an overall decline of $934 million or 8.2 percent. This compares with an average annual growth rate of 1.9 percent in the previous period.
- Of the major taxes, sales/use tax and income tax receipts declined 11 percent and 10.5 percent, respectively. State education tax collections fared better than the overall rate, but still declined 1.9 percent from FY2008. All three taxes had positive annual growth rates from FY2001 to FY2008.
- The real estate transfer tax fell 26.2 percent year-over-year. This was the only tax that had negative growth in the FY2001 to FY2008 period, falling 5.5 percent per year on average.
- Lottery proceeds are expected to fall 2.2 percent after showing modest growth of 3.4 percent per year over the previous period.

From the reduced base in FY2009, revenues are estimated to decline further in FY2010, largely due to continued economic struggles nationally and in Michigan. Specifically, year-over-year projected changes suggest:

- Two of the three major tax revenue sources (income and property) will fall and aggregate tax revenue from all sources will decline $170 million (1.6 percent).
- Income tax receipts will decline by $80 million (4.2 percent) as the state continues to shed payroll jobs.
- State education tax will decline by $147.6 million (7.2 percent), largely as a result of the declining real estate market.
- Tobacco taxes will drop again (5.6 percent), reflective of the continued decline in tobacco use.
- Lottery proceeds will remain basically stagnate at their prior year level, reflective of the limited discretionary income that residents have and competition from other gaming.

Chart 15
ARRA Funds Used to Achieve SAF Budget Balance: FY2009 through FY2011



* Based on Enacted FY2011 budget (Public 110 of 2010).

American Recovery and Reinvestment Act of 2009

The revenue declines in FY2009 and FY2010 will not be fully reflected in the level of education services delivered in Michigan over this period. These shortfalls will be partially offset by the availability of temporary federal assistance provided through the American Recovery and Reinvestment Act of 2009 (ARRA). The ARRA legislation was enacted in the early part of 2009 and the federal resources are designed to help states mitigate cuts to public services and maintain required state budget balance over a three-year period, 2009 through 2011. Specifically, a significant portion of the $878 billion in ARRA resources targets education service providers at both the K-12 and higher education levels. The ARRA education funds are distinct from the on-going federal resources that many Michigan schools receive through the annual state School Aid Fund budget in two primary ways. First, ARRA resources are provided on a temporary basis and in a single lump sum for states to use beginning in 2009. Second, a significant portion of the funding is discretionary, in contrast to on-going federal funds that are generally restricted to specific purposes. (Note: The Michigan Department of Education reports that it will receive $2.6 billion in ARRA grants in total, one-half of which is discretionary education funding. The remainder will be used to support existing federal programs, notably Individuals with Disabilities Education Act ($401 million), Title I – Improving the Academic Achievement of the Disadvantaged ($390 million), and other smaller grant programs. [i])

With respect to undesignated funding, ARRA provides the State of Michigan with a formula allocation of $1.6 billion to support its general budgetary needs. Of this total, $1.3 billion is earmarked by federal law to finance public education services at the K-12 and postsecondary levels. Michigan's application for this funding designated a little more than $1.2 billion for K-12 education in FY2009, FY2010, and FY2011 and $68 million for public universities in FY2010.[ii] Some restrictions accompany the funds, but generally few "strings" accompany the funding and they may be used to support ongoing budget items at the local school level. Because of this freedom, these federal resources are indistinguishable from state revenues provided to local schools through the School Aid Fund and individual schools will determine how best to use these resources, keeping in mind their temporary nature.

In nominal terms, the amount of ARRA education money was not spread equally over the three years, but was "front-loaded" ($600 million) to help address the revenue decline in FY2009. The School Aid Fund budget relied on $450 million in FY2010 and the remainder ($184 million) in FY2011. The use of significant amounts of non-recurring ARRA dollars in FY2009 and FY2010 had the effect of postponing the fiscal impact associated with declines in SAF revenue declines in those years. The $600 million used in FY2009 accounted for 5.3 percent of the School Aid Fund budget and the $450 million currently set-aside for FY2010 is equal to 4.2 percent of the projected SAF budget expenditures. The remaining ARRA dollars available in FY2011 represent less than half the amount available in FY2010 (**Chart 15**).

In August 2010, additional temporary federal resources through the Education Jobs Fund (Public Law 111-226) were made available to the states to maintain and create public education jobs in the 2010-11 school year. A total of $10 billion is available for distribution to the states and Michigan's projected share of the total is $318 million. At the time of this writing, state officials are in the process of applying for the additional resources and determining how to distribute them to individual local districts in FY2011. While these decisions will influence the funding received at the local level in FY2011, both in the aggregate and on a per-pupil level, the specifics are unknown at this time. However, at a system-wide level, the additional funding will be added to the $184 million in ARRA funding currently programmed for FY2011, thus raising the amount of temporary federal resources to $500 million and increasing the portion of state education spending supported by non-recurring resources from 1.7 percent to 4.4 percent.

[i] Michigan Department of Education, *ARRA Monitoring*, presentation to Michigan State Business Officials Workshop on June 9, 2010. www.msbo.org/library/Presentations/2010BizMgr/ARRA.pdf

[ii] House Fiscal Agency. *American Recovery and Reinvestment Act Funding and Michigan's State Budget*. December 2009.

Local Property Tax Revenues

The 1990s school finance reforms reduced substantially the role played by locally-generated revenues in the overall financing of public elementary and secondary education. In percentage terms, the roles of state and local operating revenues were reversed after the adoption of the 1994 constitutional amendment and the associated statutory changes. On a rough order of magnitude, the local responsibility for financing the operating costs of local school districts was reduced from nearly two-thirds in FY1994 to about one-quarter in FY1995. For Michigan's intermediate school districts (ISDs), which also provide specific, targeted education services (notably special education), Proposal A and its statutory reforms did not result in the same shifts in funding responsibility between levels of government.

At the time of their enactment, these constraints were deemed necessary to address taxpayer resistance to past repeated requests to raise local school operating tax rates. Also, it was argued that state efforts to correct per-pupil revenue inequities through a centralized revenue system would be partially undone if local districts could seek additional revenues through higher property taxes.

From an operating revenue perspective, local revenues remain an important component of the overall financial picture for public education; however, the performance of local tax revenue plays a much less important role in the amount of funding that an individual district receives under the Proposal A financing scheme. Property tax revenues continue to represent the largest share of the local component of school operational funding, accounting for $9 of every $10 in locally-generated resources. Although these resources are a key component of the per-pupil foundation allowance program, the state controls the amount of the grant for each district and supplies the resources to account for the difference between the grant and the locally-raised property taxes. Thus, local property tax performance does not directly determine the per-pupil revenues received in a local district under the centralized revenue structure. [Note: For intermediate school district, local property tax performance still plays an important role in determining per-pupil revenue levels each year.] **Appendix A** provides a very brief descriptive overview of local school operating property taxes in Michigan available to local and intermediate school districts. We do not discuss the role of property taxes in financing capital expenditures in this report.

By design, the new financing system placed tight limits on the ability of local school districts to generate additional revenues locally, specifically from the property tax. At the time of their enactment, these constraints were deemed necessary to address taxpayer resistance to past repeated requests to raise local school operating tax rates. Also, it was argued that state efforts to correct per-pupil revenue inequities through a centralized revenue system would be partially undone if local districts could seek additional revenues through higher property taxes.

Operating Property Tax Revenue Performance

The property tax is the dominate own-source operating revenue for local and intermediate districts. Other local revenue sources that support school operations to varying degrees include food service, investments, and other miscellaneous revenues. Local operating property tax revenues have exhibited consistent and steady growth since the adoption of Proposal A. This consistency results from the general stability that the property tax exhibits over turbulent economic times vis-a-vis income and consumption taxes. Furthermore, this stability is also due to the various constitutional tax limitations that effectively cap property tax revenue growth for all units of local government, including schools.

Local Districts

Local operating property tax revenues, including the 18-mill, "hold harmless", and enhancement taxes, grew from $2.0 billion in FY2001 to $2.7 billion in FY2008, an aggregate increase of 39 percent, which equates to an annualized rate of 4.9 percent (**Table 9**). Annualized growth rates of the major and minor state taxes going to education were 1.7 percent and 4.3 percent, respectively, over the same period. Local property taxes fared extremely well compared to economic activity over the period as state personal income increased 2.2 percent per year. Tax receipts also outpaced increases in general prices (changes in the U.S. CPI averaged 2.4 percent per year over the same period).

In FY2009, property tax collections for operations were significantly affected by enactment of the Michigan Business Tax and related legislation, which provided certain exemptions from the 18-mill tax to industrial and commercial property. In that year there was a 9.1 percent net reduction in local property tax revenue, from $2.7 billion to $2.5 billion. This local revenue reduction was offset by increases in state funds dedicated to education in FY2008 and FY2009.

Table 9
Growth of Local and State Education Operating Taxes
(Dollars in Millions)

	Local Property Tax*	Change	Major** State Taxes	Change	Minor*** State Taxes	Change	Total Operating Taxes	Change
FY2001	$1,951.4		$8,520.8		$886.3		$11,358.5	
FY2002	2,060.3	5.6%	8,575.0	0.6%	945.3	6.7%	11,580.7	2.0%
FY2003	2,153.1	4.5%	9,066.8	5.7%	1,061.9	12.3%	12,281.8	6.1%
FY2004	2,197.2	2.0%	8,873.6	-2.1%	1,096.8	3.3%	12,167.7	-0.9%
FY2005	2,334.9	6.3%	9,173.6	3.4%	1,068.8	-2.6%	12,577.2	3.4%
FY2006	2,451.8	5.0%	9,332.7	1.7%	1,061.3	-0.7%	12,845.8	2.1%
FY2007	2,586.1	5.5%	9,420.3	0.9%	984.0	-7.3%	12,990.3	1.1%
FY2008	2,697.0	4.3%	9,584.8	1.7%	1,187.5	20.7%	13,469.2	3.7%
FY2009	2,452.6	-9.1%	8,730.7	-8.9%	1,468.5	23.7%	12,651.8	-6.1%
FY2010****	2,508.6	2.3%	8,582.1	-1.7%	1,452.8	-1.0%	12,543.5	-0.9%
Annual Rate	2.8%		0.1%		5.4%		1.1%	

* Includes three operating property taxes – basic 18-mills, "hold harmless", and regional enhancement

** Includes State Education, Sales and Use, and Income taxes

*** Includes all minor taxes dedicated to the School Aid Fund (excludes General Fund and lottery proceeds)

**** Estimates based on May 2010 revenue estimates

Source: Michigan Department of Education; Michigan Department of Treasury

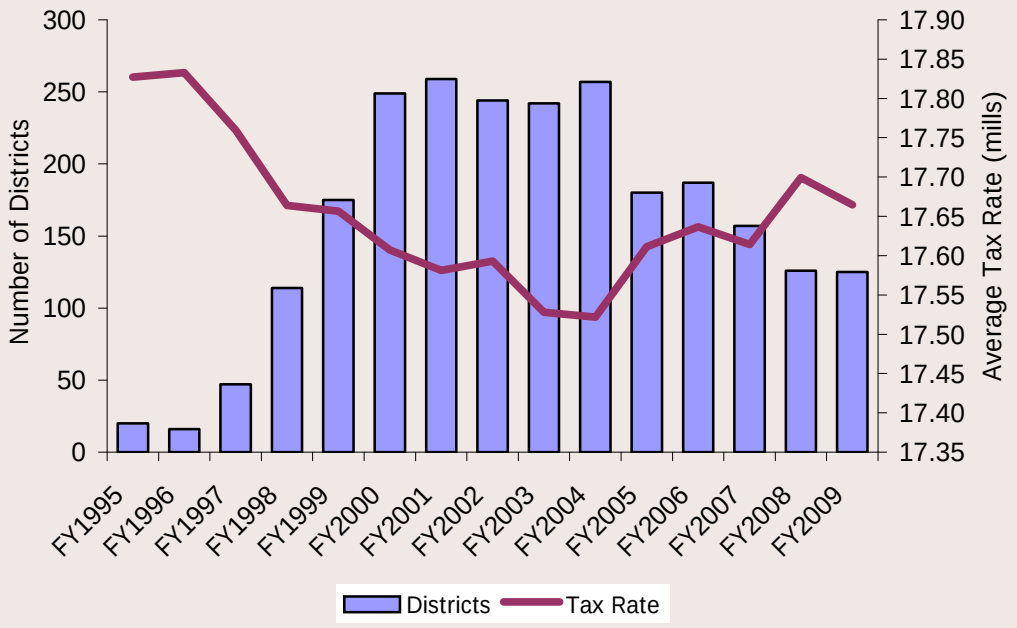
Property tax collections are projected to grow by 2.3 percent in FY2010, a much lower rate than was experienced in the period FY2001 through FY2008.

Following the adoption of Proposal A and largely as a result of the strength of the housing market and resultant growth in property values in Michigan, a number of local and intermediate school districts have experienced "Headlee rollbacks". [Note: Article IX, Section 31 of the 1963 Michigan Constitution requires property tax rates (including schools) to be "rolled back" when the growth in assessed value, excluding new construction, exceeds the growth in inflation.] As shown in **Chart 16**, initially only a few local districts were subject to constitutional tax rate reductions, but the number gradually increased. By FY2001, a total of 259 districts (47 percent of all districts statewide) in Michigan were levying fewer than 18 mills. [Note: This includes a small number of districts that were doing so prior to Proposal A and were "grandfathered" under the new financing system.]

The gradual increase in the number of districts levying fewer than 18 mills on non-homestead property is reflected in the statewide average tax rate for this local property tax. As more local districts experience millage rate rollbacks, the average figure declines, as depicted in **Chart 16**. The average figure bottomed out in FY2004 (tax year 2003) at 17.52 mills. In FY2009, the statewide average is up slightly at 17.66 mills, but still below the maximum limit.

In recent years, the number of districts levying fewer than 18 mills has declined. This is explained by a couple of factors. First, as authorization for the local school operating property tax expires, electors are asked to renew the tax at the full 18-mill rate.[15] A second reason is the approval, at the local level, of millage rate increases intended to "override" the previous Headlee rollback.[16] When these questions gain approval at the local level, the rate can be returned to the maximum 18 mills. For FY2009, 125 districts, less than half as many as FY2004, levied

Chart 16
Local Districts Levying Less than 18 Mills on Non-Homestead Property and Average Tax Rate



Source: Michigan Department of Education

the local school operating tax at a rate below the maximum 18 mills.

Intermediate School Districts

The centralization of school finances at the state government level did not affect intermediate school districts (ISDs) as severely as it did local school districts. Although amounts vary across districts, as a group, ISDs continue to receive the majority of their funding from local sources, in much the same way as they did before Proposal A.[17] Considerable variation in property taxation exists among ISDs, something that predated Proposal A. The variation in local tax effort among ISDs explains some of the service discrepancies that exists statewide. The variation in ISD services is fully explained in a separate report, *Public Education Governance in Michigan*.[18] In FY2008, local resources comprised 60 percent of all ISD funding statewide, followed by 18 percent from state sources, and 22 percent from federal sources. Federal sources constitute a larger share of overall ISD finances compared to local districts because of the leading role ISDs play in the provision of special education services. Again, considerable variation exists among ISDs as to the component shares of each district's total budget. As is the case with local districts, the major own-source revenue available to ISDs is the property tax.

The centralization of school finances at the state government level did not affect intermediate school districts as severely as it did local school districts.

ISDs have authority to levy property taxes for: 1) general operations, 2) special education operations, and 3) vocational education operations. Authorization to levy dedicated taxes for special education or for vocational education, and as part of the school finance reform for increased general operating millages, requires voter approval. The maximum rate for each purpose is capped and all ISD tax rates are subject to Headlee tax rate rollback provisions of the Michigan Constitution.

The 57 ISDs across the state rely on the three different taxes to varying degrees. The revenue growth experienced statewide, and at the district-level, depends on a number of factors, including the rates levied for each tax and changes in the tax base within each community.

Beginning in 1995 and as part of the new financing system, a cap on the general operating tax rate that an ISD can levy was established at 1.5 times the number of mills allocated to the ISD in 1993. All districts in FY2001 levied the tax, but considerable variation existed among the rates ranging from 0.0727 mills (Livingston Educational Services Agency) to 0.4675 mills (Muskegon Area ISD). The average rate statewide was 0.2184 mills, an amount which has remained fairly constant over the years.

Statewide in FY2009, the general operating tax generated almost $63 million, an increase of 48 percent over the aggregate yield in FY2001 (See **Table 10**), despite the fact that the average tax rate declined very slightly over the period to 0.2121 mills. This shrinkage was the result of tax rate rollbacks required because of tax base growth. Growth in the total ISD tax base between FY2001 and FY2009 was 52 percent. Growth in the base (48 percent) and yield (52 percent) over the period substantially exceeded changes in the rate of inflation, which rose only 17 percent over the eight-year period.

Receipts from the general operating tax increased at a very strong and steady rate between FY2001 and FY2008, averaging 5.5 percent per year. This growth was fueled by the increase in the value of property. The year-over-year change in FY2009 was much lower (1.3 percent), a reflection of a slowdown in the escalation of property values statewide (1.1 percent). Early estimates of tax yields for FY2010 indicate a very small decrease (-0.2 percent) statewide; however, this moderate reduction hides some significant variation in the experiences at the individual district level. Again, changes reflect the declining tax bases. Although the statewide total taxable value for ISD millages is projected to decline a very modest 0.6 percent, changes at the district level range from an increase of 13.7 percent (Gogebic-Ontonagon) to a decline of 3.6 percent (Genesee).

Given ISDs' primary role to provide special education services both directly and indirectly through constituent school districts, it is not surprising that the special education property tax is the largest revenue source, yielding a little over $1 billion in FY2009

Table 10
Intermediate School District Property Tax Bases and Yields
FY2001 to FY2010 (est.): Selected Years
(Dollars in Millions)

	Taxable Value	General Operating Millage	Special Education Millage	Vocational Education Millage	Total Yield
FY2001	$236,240	$42.3	$531.3	$122.7	$696.3
FY2005	301,486	$52.6	$862.4	$166.7	$1,081.7
FY2008	354,763	$61.6	$1,026.2	$199.0	$1,286.8
FY2009	358,723	$62.5	$1,037.8	$202.1	$1,302.4
FY2010 – est.	356,725	$62.4	$1,032.8	$201.8	$1,296.9
Annualized Growth Rates					
FY2001 to FY2008	6.0%	5.5%	9.9%	7.2%	9.2%
FY2009	1.1%	1.3%	1.1%	1.6%	1.2%
FY2010	-0.6%	-0.2%	-0.5%	0.0%	-0.4%

Source: Michigan Department of Education

and accounting for 80 percent of ISDs' total property tax collections. The statewide average rate for this tax was 2.54 mills, up from 2.40 mills in FY2001.

The Revised School Code limits an individual district's special education millage rate to 1.75 times the number of mills levied in 1993, so the maximum allowable rates vary across the state. To increase the rate above the level in effect in 1993 requires a local vote. In FY2009, all 57 districts levied this tax, with the lowest rate 0.6371 mills (Iosco Regional Education Services Agency) and the highest rate 5.6264 mills (Jackson ISD). Growth in special education property tax yields has been significant, nearly doubling between FY2001 and FY2009. This growth is a function of tax rate increases as well as growth in the property tax base. In comparison to the average general operating millage rate, which declined nearly 3 percent between FY2001 and FY2009, the statewide average special education tax rate increased from 2.40 mills to 2.54 mills, 6 percent, over the same period. The increase in the statewide average figure is evidence that ISDs have sought, and gained local approval for, rate increases above the levels in place in 1993. As was noted with the general operating tax, yields from the special education tax levy grew much slower in the most recent period (only 1.1 percent in FY2009), compared to nearly 10 percent per year on average between FY2001 and FY2008. Special education property tax accounts for the robust growth of overall ISD property taxes in recent years.

In contrast to local school district finances that are dependent on the performance state taxes, ISDs fared relatively well between FY2001 and FY2009 when state revenue growth stagnated. Looking forward, however, the revenue picture facing ISDs is likely to change with the challenges facing the property tax. Statewide figures suggest that all three ISD property tax levies will decline in FY2010 in response to falling tax bases, yielding an aggregate decline in property tax revenues (See **Table 10**).

While all ISDs levied the general operating and special education taxes in FY2009, only 31 districts levied the vocational education millage for area-wide programming in that year. Of this group, over one-half (18 districts) levied the tax at a rate in excess of 90 percent of the maximum allowed. For those districts close to the maximum rate, raising tax rates to compensate for falling property values may not be an option. (See *Raising ISD Property Tax Rates* box on p. 43.) Also, those districts that were not levying the tax in 1993 are faced with a hard cap on the maximum rate allowed (1 mill), while those that were levying the tax prior to Proposal A can increase the maximum rate by 1.5 times the millage rate in 1993.

Raising ISD Property Tax Rates

All units of local government will experience fiscal challenges resulting from deteriorating property tax bases in the coming years; however, within the school community, ISDs will be particularly hard hit by falling property values and the attendant property tax yields because of their heavy reliance on this revenue source to support operations. Deterioration of the tax base will require tax rate increases to maintain revenue levels, or districts will have to pare back services to meet depressed revenue collections. State law authorizes ISDs to increase tax rates above those in place upon Proposal A's adoption, subject to local voter approval and subject to limitations.

Like so many local governments in Michigan, intermediate school districts have been affected to varying degrees by property tax rate rollbacks that have occurred automatically in response to escalating property tax bases in the past [Note: Headlee tax rate rollbacks of ISD tax rates are observed in the distribution of tax rates for FY2001 and FY2009.] In FY2001, the average district was levying the general operating tax at 93.3 percent of the maximum voter-approved rate and only one district was levying at the maximum (**Chart 17**).[1] By FY2009, the average operating millage rate statewide had declined to 90.6 percent of the maximum and no districts were at their authorized cap.

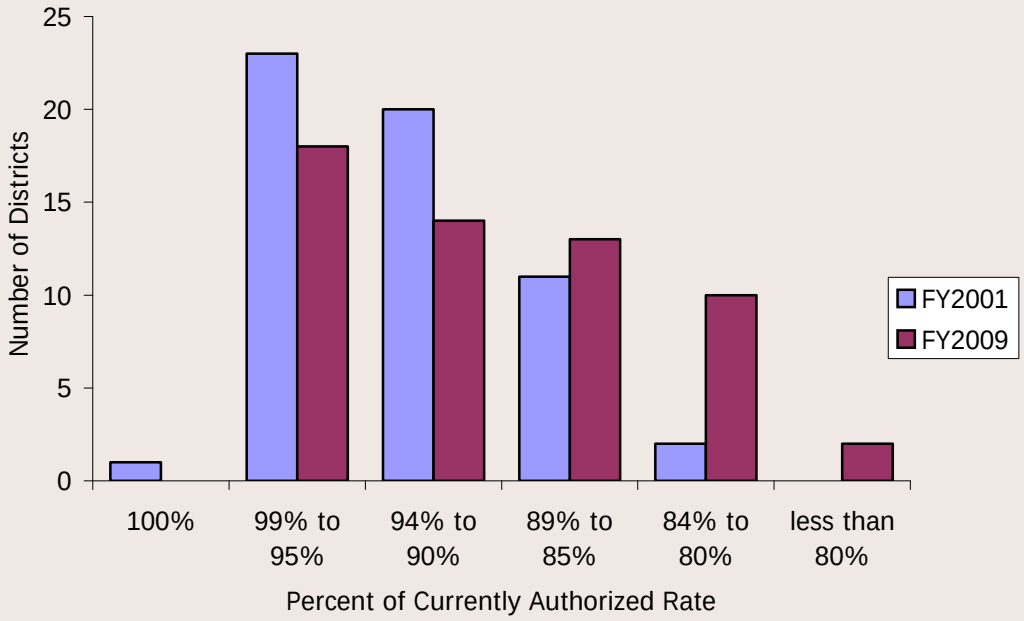
Headlee tax rate rollbacks affected special education millages in the same way between FY2001 and FY2009. In FY2001, the average rate for these millages statewide was 92.1 percent of the maximum and by FY2009, districts were levying at 90.4 percent of the maximum rate (**Chart 18**). Assuming districts have not done so already, the reduced tax rates resulting from the Headlee rollbacks effectively provide room for nearly all districts to increase rates, subject to voter approval, up to the levels previously authorized. Initially, rates will only be able to be raised, or restored, to the level previously authorized, i.e. via an "override" vote. However, fully restoring the "rolled back" rates may not be sufficient to make up for the decline in property tax values.

For districts with little or no room currently under voter-approved maximum rates to make up for the potential losses stemming from property values, Proposal A provided a mechanism to increase the maximum tax rate for each of the three taxes levied by ISDs. Very few districts have taken this action so far, so most have considerable room under the Proposal A rate limitation for the general operating, special education, and vocational education millages. This will allow districts to respond to falling property values by increasing rates, a response that may or may not be politically acceptable.

Thus far, few ISDs have sought voter approval to increase the general operating or the special education millage rates above those in effect when Proposal A took effect. When districts have sought to increase the maximum tax rate allowed, the special education tax rate has been increased. A total of 17 ISDs have taken the necessary steps to ask voter approval to raise the maximum special education rate allowed under state law, which means nearly three-fourths of the all districts remain well below the state statutory maximum rate allowed under Proposal A (i.e., 1.75 times 1993 rate). In one-third (six districts) of the cases where voters have been asked to raise the rate above the 1993 rate, the rate was raised to the statutory maximum (1.75 times 1993 rate). In five of the six districts, the FY2009 special education millage rate was at least 95 percent of the respective maximum rate. For these five districts, the option of raising tax rates in response to declining property values over the coming years will be constrained by the statutory caps adopted as part of the Proposal A reforms.

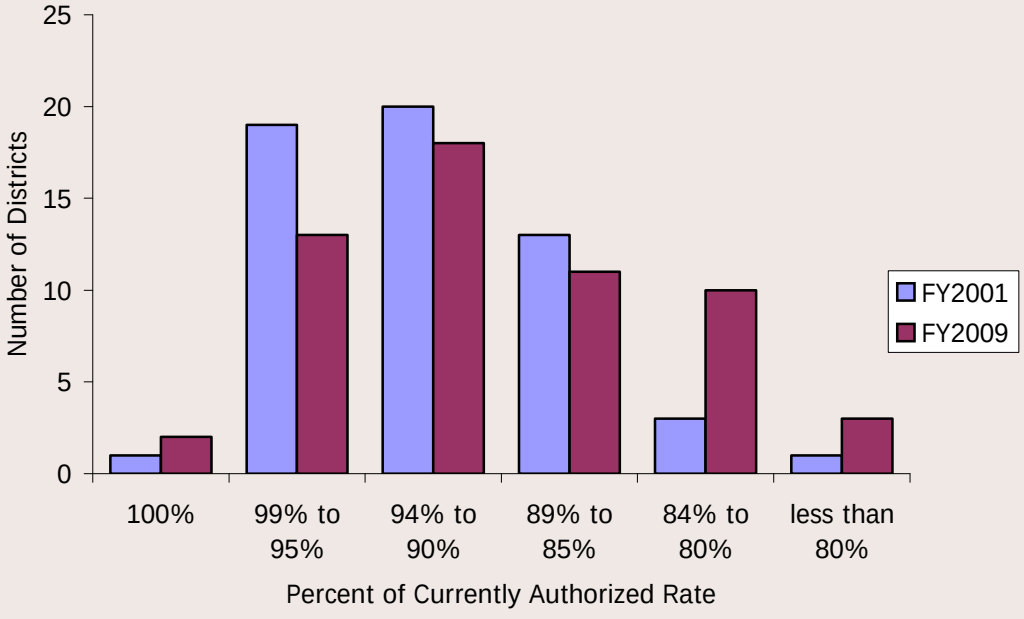
[1] To obtain the information regarding ISD millage rates, the Citizens Research Council of Michigan, working with the Macomb Intermediate School District, collected information from all 57 ISDs. Districts provided information pertaining to authorized millage rates and actual millage rates for three fiscal years, FY1994, FY2001, and FY2009. FY1994 represented the "base year" for purposes of determining the statutory limitations on tax rates for general operations, special education, and vocational education. Rates, both authorized and actual, for FY2001 and FY2009 were analyzed to determine how much room, if any, individual districts had under both the currently authorized limitation as well as the state-imposed limitation. Data from this survey is available, upon request, from CRC.

Chart 17
ISD Operating Property Tax Levies: FY2001 and FY2009



Source: CRC Survey of ISDs

Chart 18
ISD Special Education Property Tax Levies: FY2001 and FY2009



Source: CRC Survey of ISDs

Public Education Spending

As previously noted, the primary focus of this paper is the revenue side of the public education ledger. The broad purpose is to examine the resources, state and local, available to support public education in Michigan and the performance of these revenues since the passage of Proposal A. As part of CRC's efforts to explore school finances in a comprehensive manner, a separate analysis of school spending issues and pressures will be forthcoming. In light of the discussion about the manner in which revenues for education are obtained in Michigan, it is instructive to provide the reader with a primer on the expenditure side. To this end a general picture of public education spending and how it contrasts with state General Fund spending can be helpful.

While the majority of financial support for public education comes through the State of Michigan's annual School Aid Fund (SAF) budget, the nature and scope of education spending financed by the SAF is different than much of the programs and services financed by the other major budget,General Fund. These differences are important in the context of understanding the cost drivers within school budgets as well as how they compare with the drivers affecting other General Fund expenditures each year. Examining the unique nature of public education spending is also helpful when consideration is given to reducing expenditures at the local or intermediate district level. Because of the high concentration of personnel spending, the options for effecting major spending reductions are limited. Personnel costs tend to be "sticky" in the short-term and immediate reductions are difficult to achieve because multi-year collective bargaining agreements determine overall employee compensation.

Nature and Scope of Spending

Even though the vast majority of school revenues originate from state taxes which are appropriated through the annual State of Michigan budget, local and intermediate school district budgets bear little resemblance to the larger state budget. Less than 20 percent of the total annual expenditures made by the State of Michigan finance programs operated directly by the state. Over 80 percent of all funds appropriated in the budget each year are distributed for services delivered by organizations other than state departments and agencies in functional areas where the State of Michigan is responsible for service provision, either directly or indirectly. A large portion of state government's role as a "contract manager" to other sub-state entities is mandated in the 1963 Michigan Constitution (Article IX, Section 30), which requires that a minimum of 49 percent of state-source revenues each year must be paid to units of local government.[i]

In contrast to the state budget, the vast majority of school expenditures finance programs operated directly at the local or intermediate district level. This contrast is clearly seen in the share of personnel costs that comprise school budgets compared to the state budget. For example, the Michigan Civil Service Commission reports that approximately 11 percent of total State of Michigan expenditures in FY2009 ($44.3 billion) financed the classified payroll of state employees, a percentage that has remained fairly constant for the last 10 years.[ii] This compares with nearly 80 percent of total school operating spending ($17.3 billion) dedicated to personnel expenses for the same period. Personnel-related expenditures include payroll costs, group health insurance liabilities, and retirement (pension and other post-retirement benefits) contributions. Personnel costs in any given year are contingent on a number of factors, including the number of employees, increases in pay, changes in benefits, and required contributions to finance retiree benefits.

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[i] Article IX, Section 30 of the 1963 Michigan Constitution, added as part of the "Headlee Amendment" in 1978, requires the state to maintain the proportion of state spending to local units in at least the same proportion as that which was in effect in FY1979, the base year. The base year proportion was originally computed to be 41.61 percent. Effective with FY1993, a recalculation was made of the base year proportion as a consequence of a settlement agreement reached on the County of Oakland v State of Michigan lawsuit, which was settled in 1991. The recalculated base year proportion is 48.97 percent.

[ii] Michigan Civil Service Commission, *Thirtieth Annual Workforce Report FY2009*.

Employee Payroll

Between FY2000 and FY2009, the number of full-time equivalent (FTE) positions reported by all school entities (local and intermediate school districts and public school academies) in Michigan fell from 210,027 FTE positions to 207,910 FTE positions, representing a very modest 1.0 percent drop (See **Table 6**). Comparing the changes by service provider reveals significant variation in personnel level over this period.

The number of FTEs in traditional local districts declined by almost 14,000 positions (-7 percent), while ISDs, in the aggregate, gained 6,700 positions (81 percent). It is likely that a number of factors can explain the two different stories. The fiscal challenges present at the local district level during this period, coupled with personnel effects that accompany declining student enrollments at the district level, account for some of the decline. To some degree, overall ISD finances were not as acutely affected by the downturn in state revenues earlier in the decade because of the large role played by local property taxes, thus personnel levels were not reduced. Similarly, although not immune to the effects of declining student numbers, aggregate ISD funding levels were not adversely affected to the same degree as local districts from the shifting demographics. Finally, it is possible that some of the ISD employment gains could be attributed to a shift in program responsibility (e.g., special education services), from the local to the intermediate district level. The fiscal constraints on local districts (declining state revenues and restrictions on local revenue supplementation) may have resulted in certain districts shedding service delivery and transferring responsibility to the ISD. The transfer of special education services to the ISD level may have been facilitated further by how the state reimbursed districts for special education costs following the *Durant* case in 1998.

The near-doubling (96 percent) of FTE levels from FY2000 to FY2009 within the charter community was almost entirely in response to the growth of the number of charter schools in the state and attendant enrollment increases. According to pupil headcount figures reported by the State of Michigan, enrollments at charters increased from 46,833 students in FY2000 to 103,444 students in FY2009, an increase of 120 percent. In contrast, the traditional K-12 district enrollment levels declined by 6.4 percent during the same time, from 1,617,010 students in FY2000 to 1,513,604 students in FY2009.

By far, teachers (non-special education) represent the largest portion of the overall education workforce accounting for 37 percent of the total FTE count for all reporting entities in FY2009. At the ISD level, teachers only represent two percent of the total workforce and special education (instructional, administrative, and support) accounts for 47 percent. Teaching positions dominate within the traditional local and charter school landscape. The average salary for the teachers statewide climbed 27 percent, from $49,044 in FY2000 to $62,272 in FY2009, an increase that outpaced changes in Michigan per-capita personal income over a similar period (16 percent) and changes in the U.S. CPI (20 percent).[iii]

[iii] Data from the Michigan Department of Education annual publication, Bulletin 1014.

Table 11
Changes in Public Education Employment Levels: Selected Years
Full Time Equivalent (FTE)

	Local Districts	ISDs	PSAs	Total
FY2000	196,588	8,311	5,127	210,027
FY2004	185,158	12,054	7,046	204,258
FY2009	182,824	15,045	10,041	207,910
Change 2000 to 2009	(13,765)	6,735	4,914	(2,116)
	-7.0%	81.0%	95.8%	-1.0%

Source: Center for Educational Performance and Information

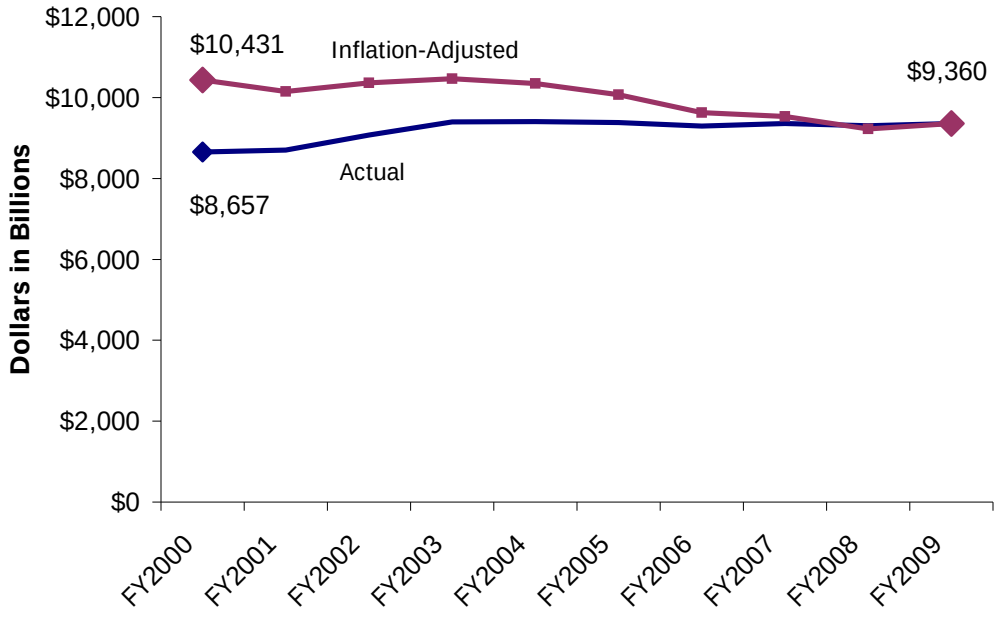
Expenditures for all school employees' salaries totaled $8.7 billion in FY2000 and $9.4 billion in FY2009. After rising consistently through FY2004 ($9.4 billion), payroll figures have remained fairly flat since. Even though FTE positions decreased, the cost of paying each employee grew due to salary and benefit cost increases. After adjusting payroll expenditures for inflation, the cost declined by 10.3 percent between FY2000 and FY2009, while FTE positions declined by 1.0 percent during the same period. **Chart 19** compares actual school employee payroll expenditures with inflation-adjusted expenditures between FY2000 and FY2009. Not included in this chart is the employers' costs of required taxes (Medicare and Social Security), which is a fixed amount of payroll (7.65 percent currently). These amounted to a little over $700 million in FY2009 and have grown commensurate with growth in payroll.

Group Insurances

In addition to payroll, other major employee-related expenses of public education providers are fringe benefits, the largest of which is health care insurance for current employees and their families. The level and type of benefits are determined at the individual school district level for the most part, and are subject to collective bargaining. In most instances, the cost of the insurance is shared by both the employer and the school employee; however, the relative shares paid by each vary across school districts and charter schools. Health insurance represents the second-largest personnel expenditure and a rapidly growing component of education budgets at all levels.

In FY2009, the total amount spent on group insurances (primarily health insurance) was $2.1 billion, almost one-quarter of the base payroll figure for the year. This

Chart 19
Public Education Payroll Expenditures: FY2000 to FY2009



Source: National Public Education Financial Survey; U.S. Department of Commerce

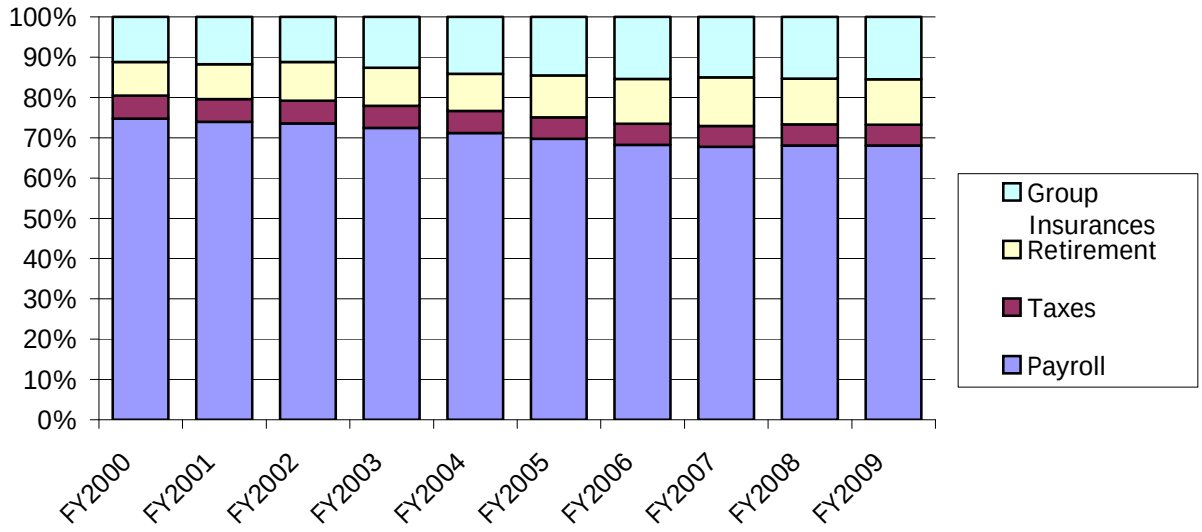
component has become an increasingly larger portion of the total employee compensation picture for schools as it has grown from $1.3 billion in FY2000, a 64 percent increase (See **Chart 20**). The cost of insurance has increased faster than any other employee-related expense during the period. This growth has occurred despite a reduction in the number of employees and in direct response to the price inflation associated with health care.

Retirement Benefits

Spending required to satisfy retirement benefits (pensions and health insurance) increased nearly 60 percent between FY2000 ($970 million) and FY2009 ($1.5 billion). Employer-paid retirement contribution amounts are calculated based on a percent of active payrolls to finance three things: 1) future pension benefits of current employees (normal cost); 2) unfunded liabilities of the pension system; and 3) health care benefits for current retirees. Normal cost is the amount needed to cover the present value of benefits earned by system members in each fiscal year and unfunded liabilities are liabilities that are not covered by assets held by the system's investment funds. In FY2009, the required contribution rate for all three components was 16.5 percent of payroll. Additional contributions required to satisfy the investment losses in the retirement portfolio for 2001 and 2002 caused the total pension component to rise from $572 million in FY2000 to $911 million in FY2009.

The growth in annual spending for retiree health was moderated to some extent through the use of reserves, which resulted in the contribution rate for this component rising from 4.6 percent of active payroll in FY2000 to 6.8 percent of active payroll in FY2009. Reserves were used to augment annual contributions for a three-year period (FY2004 to FY2006). In nominal terms, schools spent $637 million in FY2009 to finance the actual costs of retiree health, up from $398 million in FY2000. As a result of the rapid growth rate of retiree health and pension contributions, the retirement share of the overall school personnel budget increased from 8.4 percent in FY2000 to 11.3 percent in FY2009 (See **Chart 20**). A number of factors account for the rise in the employer

Chart 20
School Personnel Expenditures: FY2000 to FY2009



Source: National Public Education Financial Survey.

contribution rate required to finance retiree health costs: 1) increased number of retirees; 2) decreased number of active employees; 3) shrinking active payroll base; and 4) general cost increases of health care services (See **Table 12**). Prospectively, if these factors continue to exhibit the same growth rates, the retiree health component of school budgets will become even larger, pulling current dollars away from other school spending.

As of September 30, 2009, there were 268,208 active members in the school retirement system and 171,922 retirees and beneficiaries receiving benefits. The number of active members has been declining since FY2003 while the number of retirees has steadily increased, meaning that, each year, there are fewer active employees to finance the benefits of more retirees. The reported payroll, the base of employer contributions, fell each year from FY2005 through FY2007, before increasing slightly in FY2008 (See **Table 12**).

Unlike the other employee-related costs facing schools, school districts have no control over the retirement contribution rate, which is set annually by the State of Michigan along with the benefit level. Because there has been no pre-funding of the retiree health benefit, current budget dollars have to be used to finance this benefit. In contrast, the pension benefits promised by the retirement system are pre-funded to satisfy future obligations; however, this component is sensitive to the performance of the systems' investments relative to actuarial assumptions.

Other Spending

After accounting for employee-related expenses, the remaining 20 percent, or about $3.5 billion, of the total operating expenditures ($17.3 billion in FY2009) comprise a number of smaller categories, the largest of which include transportation, athletics, and food. Traditionally, this cost grouping has risen at rates below the annual growth rates observed for employee/retiree health spending, but above the annual growth in inflation (U.S. CPI).

Table 12
Michigan Public School Employees' Retirement System: FY2000 through FY2009

	Active Members	Retirees and Beneficiaries	Ratio of Retiree to Active	Reported Payroll (Dollars in Millions)
FY2000	312,699	126,115	1:2.5	$8,984.7
FY2001	318,538	130,790	1:2.4	9,264.2
FY2002	326,350	135,277	1:2.4	9,707.3
FY2003	326,938	139,814	1:2.3	10,043.9
FY2004	322,494	145,378	1:2.2	10,407.1
FY2005	316,151	151,706	1:2.1	10,206.0
FY2006	308,233	157,163	1:2.0	9,806.5
FY2007	295,984	162,844	1:1.8	9,851.5
FY2008	278,642	167,265	1:1.7	9,958.1
FY2009	268,208	171,922	1:1.6	Not Available

Source: Michigan Public School Employees' Retirement System, Annual Actuarial Valuation Report

Fiscal Outlook for Public Education

In addition to the fiscal challenges posed by Michigan's near-decade-long economic malaise, which have been exacerbated by the Great Recession, public education finances also face another serious long-term problem. Since the early 2000s, the state has failed to come to grips with the dual structural deficits affecting its major operating funds, General Fund and School Aid Fund. Such deficits are defined by a situation where a government's growth in expenditures consistently outpaces its growth in revenues. Instead of fixing the problems facing the two funds in a permanent, long-term fashion, the state has relied on a series of "stop gap" measures. Until adoption of the FY2008 state budget, annual budget balance in the two funds had been accomplished largely through such actions as delaying paying required obligations, using non-recurring revenue sources, and transferring resources from other funds to support spending in the General and School Aid Funds.[19] Despite a series of general tax increases in 2007 that generated new revenues to support the FY2008 budget, the structural problems remained largely unresolved.

Education spending was projected to grow at a rate of 4.7 percent annually, while revenues (state and local operating) were projected to grow 3.0 percent per year, resulting in a gap of 1.7 percentage points, or about $400 million each year on average.

In the spring of 2008, the Citizens Research Council issued a report entitled *Michigan's Fiscal Future,* which included, among other things, a series of projections about the performance of public education finances (state and local) for the period FY2009 through FY2017. Revenue projections based on the current financing system and a specific economic scenario were paired with projections about the spending pressures expected to face education service providers (local and intermediate school districts) over the same period. When the projections of spending pressures and revenues were combined, an increasing gap appeared representing the future structural deficit facing public education in the state. Education spending was projected to grow at a rate of 4.7 percent annually, while revenues (state and local operating) were projected to grow 3.0 percent per year, resulting in a gap of 1.7 percentage points, or about $400 million each year on average. These projections are revisited below in summary format to illustrate the long-term challenges facing the current system of financing public education. The figures are not estimates of what will happen in the arena of public education finances over the coming years, but instead represent illustrations of the factors and forces facing education budgets in the future and the likely outcomes that might materialize when reasonable estimates of revenues and spending are combined. It is not the purpose of this paper to pursue an update of *Michigan's Fiscal Future* or to provide the most up-to-date projections of school finances, rather the discussion below is intended to illustrate, in some quantifiable form, the long-term fiscal challenges facing public education.

Revenue Projections

The revenue projections included in *Michigan's Fiscal Future* were based on a long-term view of the Michigan economy. The economic picture presented in the report was not a prediction of the performance of the Michigan economy, but rather it illustrated how the state's economy might be expected to perform under a set of assumptions about the national economy and those industries especially important to Michigan. A key assumption underlying the economic projections was that the national economy would experience a 10-year period of uninterrupted growth (2007 to 2017). In this sense, the economic scenario attempted to portray long-term trends for the Michigan economy, not necessarily the short-term ups and downs associated with the business cycle or the occurrence of a more severe economic recession. The 2008 recession and its effects on the Michigan economy and the resultant state revenue impacts were not considered in the development of the long-term projections presented by CRC in the 2008 report.

It is assumed that the long-term relationships associated with the income-, consumption-, and business-based taxes dedicated to financing education remain intact, again regardless of the recession, and that these relationships will largely determine the future growth potential of state revenues.

There is little doubt that the recession has had significant impacts on all state revenues, including the major income and consumption taxes dedicated to finance public education. Education revenues declined nearly $1 billion from FY2008 to FY2009 (ignoring the effect of state business tax restructuring). The fiscal effects of the recession are expected to be felt through calendar years 2010 and into 2011, reducing state education funding in FY2010. In terms of the long-term picture facing school funding, the recession has reduced the base from which future revenues will grow. It is not expected that the recession will affect the long-term (beginning in FY2012) growth trends of the individual taxes dedicated to the SAF, as these relationships are not materially affected by the ups and downs of the business cycle. In this sense, the long-term relationships between the economy and major taxes covered in *Michigan's Fiscal Future* are still applicable today.

The long-term revenue projections made by CRC in 2008 were based on the relationships, both historically and prospectively, between the Michigan economy and the major state taxes including those dedicated to the SAF. It is assumed that the long-term relationships associated with the income-, consumption-, and business-based taxes dedicated to financing education remain intact, again regardless of the recession, and that these relationships will largely determine the future growth potential of state revenues. Over the shorter-term (two to three years) and coming out of the recession, it is likely that income and consumption taxes may experience slightly stronger growth as economic activity "ramps up" in the state; however, these are not expected to materially affect the long-term growth rates. [Note: Because the amount of the earmarked Michigan Business Tax revenues going to the SAF each year is indexed to growth in the inflation rate under current statutory provisions, the long-term relationship between the state's main business tax and the economy does not impact education finances.]

One area where school tax growth rates, at least in the near-term, may deviate from the original CRC projections is the property tax. The *Michigan Fiscal Future* report did not contemplate what has transpired with property values in the state. The original report had identified declining home prices and property values as a potential concern to the projected growth rates; however, it was assumed that it would be some time, if at all, before such declines affected taxable values and property tax receipts.

The assumed long-term growth rate of the State Education Tax (SET) was 4.25 percent, which was greater than the rate of any other SAF tax. This robust rate was based on the historical performance and stability of the property tax in Michigan; however, a number of economic variables have caused property values in the state to deteriorate substantially since the original analysis, thus driving down receipts. Although property values in some com-

munities began falling sooner than others, the gap that gradually developed over time between state equalized value (50 percent of "market" or "true cash" value) and taxable value (the basis used to calculate property tax liability) shielded tax revenues from declines. Today, in much of the state, the gap between the market value and the taxable value has been eliminated, and declining property values are being reflected in the property tax receipts at all levels, including the statewide SET. As a result, SET revenues are expected to experience year-over-year declines for some time, before reversing course and showing some marginal growth in the out-years.

CRC's 2008 report also included assumptions about the performance of local school operating property tax revenues that have proven to be too optimistic given what has occurred with these taxes in recent years and what is expected to occur over the next few years. The projections were based on this revenue source growing 3 percent per year during the forecast period, FY2009 to FY2017. This rate was slightly lower than the original SET growth rate primarily because of the different bases of each tax. Local school taxes exclude homestead property (mostly residential) from their bases, property that traditionally grew more robustly than non-homestead property. A complete revision to the original property tax revenue growth rates (both state and local) is beyond the scope of this endeavor; however, it is important to recognize that the expected rates for both the SET, which accounts for about 18 percent of total state school taxes, and the local operating taxes, are over-estimated in the short-term. Reducing the rates of growth for both taxes would have the effect of lowering the overall revenue growth rate and increasing the structural gap, especially over the short-term when property tax receipts are expected to decline year-over-year.

Table 13 presents the projected annual growth rates for each major state education tax and the minor taxes as a group. CRC's original projections included annualized rates for the other public education revenues, including federal aid (4.0 percent), lottery proceeds (2.0 percent), and local property tax revenues (3.0 percent).

Based on the assumptions about the historical relationships and performance of Michigan state and local education revenues, it was determined that the school finance system was capable of producing operating revenue growth at an annualized rate of 3 percent from FY2009 to FY2017. This rate is above the experience in the period leading up to the forecast, FY2001 to FY2007, and was justified on the grounds of an improved economic climate relative to the earlier period. While the economic picture in FY2009 to FY2010 did not materialize as previously envisioned in the *Michigan's Fiscal Future* report, the underlying relationships between the taxes supporting public education and the economy are still relevant. As the national economy begins to recover and grow coming out of the Great Recession, it is

Table 13
Projected Growth Rates of Major and Minor SAF Taxes, FY2012 to FY2017

Tax	Growth Rate
Major	
Sales	3.00%
Personal Income	3.25%
Michigan Business	2.50%
Use	3.00%
State Education	4.25%
Minor (tobacco, casino, real estate transfer, etc.)	-0.10%
Total State Taxes	3.10%

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

assumed that projected rates of growth are reasonable approximations of what the school finance system is capable of producing.

Spending Projections

In much the same way that the revenue projections for *Michigan's Fiscal Future* were developed by examining historic relationships and observing actual performance, growth in past spending was analyzed to arrive at projections for spending pressures for FY2009 to FY2017. In the earlier discussion of the general cost structure of public education, it was noted that the largest component of K-12 spending is employee compensation (about 80 percent of total). Salaries and wages account for about 59 percent of the total operating costs of local schools and fringe benefits comprise another 21 percent. The two largest fringe benefit components, health insurance and retirement, have grown at rapid rates since FY2000. A continuation of these cost breakouts and spending trends were projected forward to develop a picture of the spending pressures that would confront public education in the future.

The growth in salary expenses took into account a number of factors, including the effects of salary increases from longevity and schedule adjustments and general cost of living adjustments. The salary projections also accounted for the employee turnover and enrollment declines that will be reflected partially in reduced future workforce levels. Overall, *Michigan's Fiscal Future* report reflected annualized growth of 3.3 percent during the forecast period for school employee salaries. Pension contributions were expected to increase at the same rate as payrolls, because these benefits are prefunded (i.e., long-term stable rate) and the annual amount is expressed as a percentage of payroll.

Future spending pressures faced by schools will be driven by health care costs for both retirees and current employees. CRC's original work estimated that health care costs for retirees would rise by nearly 12 percentage points per year for two primary reasons: 1) the number of individuals eligible for the benefits was expected to increase 3 percent annually (because there has been no pre-funding, this will drive costs higher); and 2) retiree health costs will be affected by the cost of health care in general, which was assumed to rise 9 percent per year throughout the forecast, an assumption used throughout the *Michigan's Fiscal Future* report. Overall, the report assumed that the spending pressures facing schools over the eight-year period, FY2009 to FY2017, would average 4.7 percent per year, compared to 3 percent per year growth on the revenue side.

Future spending pressures faced by schools will be driven by health care costs for both retirees and current employees.

Recent changes to the Michigan Public School Employees Retirement System (MPSERS) likely will influence the long-term spending growth rates originally estimated by CRC. The changes to MPSERS requiring increased employee contributions to the system, along with provisions to require new employees to participate in a "hybrid" retirement system, will reduce employers' annual contributions to the system compared to what they would have been absent the modifications. Estimates of the long-term savings to employers from these reforms are substantial; however, it is unclear how the underlying long-term growth rate of retirement contributions will be specifically affected. Shifting a portion of the required annual contribution to the employee reduces the portion of the overall cost burden on the employer, but it likely has little effect on the future growth path of the cost component in the aggregate. However, the shift to a combined defined benefit/defined contribution plan for all new employees covered by MPSERS will have the effect of lowering the future growth rate of the employers' contributions to the system relative to what would have occurred if the defined benefit plan were retained for new employees.

The immediate effect of the reforms is to reduce the costs that public education employers will carry on their books for retirement contributions. This will help districts meet the near-term revenue challenges brought about by the economic downturn and the

reduction in the overall level of resources available to schools to provide services. However, long-term challenges still face public education funding.

In the same way that the future growth rates of property taxes have been affected by what has transpired since the publication of the *Michigan's Fiscal Future* report, changes to school retirement funding will affect the future growth of this spending category. Whereas more up-to-date projections of property tax growth will have the ultimate effect of reducing the overall future revenue growth rate, modifications to the estimates surrounding future retirement contributions changes will have the same effect on spending side of the equation. Given the different impacts of these changes, the net result, while unknown at this time, is likely to leave intact some aspect of a structural deficit facing public education.

Long-term Structural Imbalance

Deficit projections are the difference between projected revenues and projected spending pressures. The annual deficits contained in the *Michigan's Fiscal Future* report were derived by calculating the difference between the growth rates in revenues and spending pressures for public education. The long-term deficit calculations for public education revealed that there is a 1.7 percentage point difference between the annual growth rate of operating revenues (3.0 percent) and the annual growth rate of spending pressures facing schools (4.7 percent), amounting to an average annual gap of $400 million during the forecast period (FY2008 to FY2017) (See **Table 14**). CRC concluded that these annual estimates would recur unless structural changes are made in revenue and/or program policies. Because of the compounding effect of the structural imbalance, the annual deficits accumulate each year and reach $3.6 billion in the final year of the forecast. The multi-year nature of the structural problem reveals a growing gap between revenues and spending pressures, which suggests that a long-term solution to achieving on-going, sustainable balance between projected revenues and expenditures is needed.

Table 14
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.

Evaluation of Michigan's Education Revenue System

During its relatively short lifespan thus far (16 years), Michigan's education finance system has experienced both the "best of times" and the "worst of times". Furthermore, as the preceding discussion highlighted, the fiscal outlook for public education is far from rosy as components on both the spending and revenue side of the budget ledger will contribute to ongoing fiscal imbalance between projected available funds and spending pressures.

Immediately following the reforms in 1994 and through the start of the 2000s, state revenues performed relatively well compared to general measures of economic growth and annual changes in prices, exceeding these metrics in most years. On the local revenue side, despite the enactment of additional property tax limitations as part of Proposal A and their smaller role in the post-reform era, property tax yields exhibited strong and consistent growth. Coming out of this initial period and beginning in 2001, state education finances basically stagnated while local property tax revenues continued to show year-over-year growth, providing some relief to the poor performance of the major state taxes. State revenues during this second period were influenced by the 2001 recession and the major restructuring of the Michigan auto sector. Although the recession was mild by historical standards, the combined effects of the slowdown in U.S. economic output and the massive changes in the auto sector resulted in a Michigan economy that continuously lost jobs, people, and real income throughout the period.

The "Great Recession" that began in late 2007 and most likely ended sometime in the summer of 2009, has shed light on the volatility of the revenue system and has engendered considerable public attention to and interest in the various issues involved in education finance. The economic downturn has hammered baseline state revenue performance in three consecutive fiscal years (FY2008 through FY2010) and marginal growth is estimated for the upcoming fiscal year (FY2011). Under the current financing structure, the fiscal health of Michigan's 551 traditional local school districts and 232 public school academies is directly tied to state revenue performance. Michigan's 57 intermediate school districts are less reliant on state revenues; however, they have not been immune to state revenue struggles. The combination of shrinking state revenues and districts' inability to raise additional funds locally has proved challenging for districts to achieve and maintain required budget balance, especially during the recession. In nearly two-thirds of local districts, continuous annual enrollment losses have exacerbated the fiscal challenges accompanying state revenue declines. With limited options available to supplement existing state and local resources, local districts largely have focused on the spending side of the budget to reach solutions to the school funding problems resulting from the current system. Clearly, the experience in recent years suggests that the education financing system has endured the "worst of times", at least from the perspective of Michigan's local school districts.

Prospectively, the picture of how Michigan's school finance system will respond in the future is slightly clearer than it has been in recent years. For the most part, early indications suggest that the economic downturn has bottomed out and that the most severe damage to the state economy and state revenues has already taken place.

Prospectively, the picture of how Michigan's school finance system will respond in the future is slightly clearer than it has been in recent years. For the most part, early indications suggest that the economic downturn has bottomed out and that the most severe damage to the state economy and state revenues has already taken place. However, despite some signs of state revenue growth for two of three major SAF sources on the near horizon, local school districts are still sorting out the damages caused by the downturn and its effects on local budgets. Districts are also preparing for the impacts that will accompany the loss of significant levels of one-time federal resources provided to prop up local budgets

during the downturn. Furthermore, past experience suggests that a full state recovery (economic and revenue), in the best of circumstances, is still far off.

Unfortunately, as the picture surrounding state revenues stabilizes and begins to show signs of improvement, the future performance of state and local property taxes faces uncertainty, making the overall outlook for education finances less clear. Unlike state revenues which are largely dependent on the economic performance of the state economy, local property tax revenues across school districts will not be impacted uniformly, but to varying degrees depending on the interaction of property tax limitations and economic factors influencing property values at the district level. Despite this variation among districts, the general short-term growth trend (three to five years) of property tax receipts is downward. Under Michigan's guaranteed per-pupil foundation allowance program, if state revenues do not grow sufficiently to account for the lost property tax revenue, schools will continue to face the prospect of future state aid reductions. Coming out of this period of revenue decline, existing state property tax limitations will constrain revenue growth, in effect prolonging a return to current-year levels.

As state policy makers consider the myriad issues surrounding school finance, both for the near-term and the long-term, the varied and contrasting experiences of Michigan's school finance system over the past 16 years provide valuable insights into how the system reacts to various economic, demographic, and legal factors. Such observations serve a dual purpose. First, they help provide information to evaluate the system and its components. Second, these observations provide direction and suggestions for reform, should policy makers seek to implement changes in the near future.

The following discussion summarizes the main policy achievements of Michigan's school finance system and highlights some of the system's shortcomings. Examining any public finance system in isolation rather than in the context of the world it operates in has little practical usefulness and offers little direction for suggested changes. Therefore, the problematic issues raised by the current finance system are presented in the context of changes to Michigan's economy, population, and the overall condition of public finances since the mid-1990s.

Looking at the stated objectives of Michigan's school finance reforms under Proposal A, it can be concluded that the system has been extremely successful at accomplishing certain goals and relatively successful in other areas. Despite these accomplishments, the fiscal challenges confronted by the system in recent years threaten to reverse some of the achievements gained unless direct changes are made.

Successes of Proposal A

There are a number of individual measures that can be employed to evaluate any public finance system. Evaluations can be based on the grounds of efficiency, equity or fairness, transparency, and accountability, in addition to other important factors. Another equally important approach is to examine how a system has fared relative to its stated policy objectives and the degree to which improvement has been realized with respect to individual measures of interest. Looking at the stated objectives of Michigan's school finance reforms under Proposal A, it can be concluded that the system has been extremely successful at accomplishing certain goals and relatively successful in other areas. Despite these accomplishments, the fiscal challenges confronted by the system in recent years threaten to reverse some of the achievements gained unless direct changes are made.

The Proposal A reforms set out to provide broad property tax relief to Michigan residents and were highly successful in this regard. Although school operating property taxes remain part of the overall financing scheme for public education, they play a smaller role. The shift in financing responsibility from the property tax to sales and income taxes ended Michigan's ranking as one of the highest property tax states. The reduction in property taxes to sup-

port schools had a "re-balancing" effect on the overall state and local tax picture. As a result, Michigan's tax composition (mix of major taxes) in the post-reform years more closely mirrored the average U.S. state.

In order to achieve certain public policy objectives on a statewide basis, it was deemed necessary first to centralize decision-making authority regarding local school finances at the state level. Under the previous localized system, funding decisions were made at the district level by administrators, school boards, and voters. This system resulted in large disparities in per-pupil funding among school districts. Under Proposal A, a shift in decision-making authority accompanied the shift in the financing responsibility. Proposal A and its statutory components reversed the traditional roles played by local- and state-level taxes in order to provide state government with the resources, and therefore the authority, to address public policy goals, such as more equal per-pupil funding.

Unlike property tax relief which occurred almost immediately following the reforms, reducing per-pupil funding differences took some time to achieve; however, significant strides were made in the early years and later through policies that sought to "level up" low-revenue districts.

A corollary to the shift in financing responsibility was an increase in state taxes. Specifically, the Michigan Constitution was amended to increase the sales and use taxes by two percentage points to 6 percent, with the resultant revenue dedicated to education. Other statutory tax changes accompanied the rate increases of the consumption taxes and led to more state taxes being dedicated to education. When the entire state tax landscape is considered, the reforms resulted in a greater level of tax earmarking in general. In FY1993, about 34 percent of Michigan state tax revenue was dedicated to finance specific programs compared to 57 percent in FY1995. Focusing on just those state resources going to education, a higher degree of earmarking was also achieved through a reduction in the role that discretionary General Fund dollars played and an increase in earmarked revenues, both constitutional and statutory.

School finance centralization provided state-level policymakers with the authority and resources to address concerns surrounding per-pupil revenue disparities across the state. First, a new minimum level of funding was established and cemented in the state constitution. This equalization provided immediate relief to a number of chronically low-spending districts. Second, the new system provided a better mechanism to reduce inter-district revenue disparities, which were increasing under the old system. Although the state government employed mechanisms to equalize per-pupil funding among districts under the old system, it was extremely expensive to achieve high degrees of equalization among the 550-plus school districts. Under the previous system, state law makers had limited ability to control revenues generated at the local level, and they were unwilling to raise state resources to eliminate significant differences among local districts. In the post-reform era, the majority of education funding was under the direct control of state policy makers and they were able to embark on a corrective policy course to address per-pupil funding inequities.

The reforms sought relative per-pupil funding equity, not absolute equity, and thus the goal was to narrow, not eliminate, the gap that existed between districts. Unlike property tax relief which occurred almost immediately following the reforms, reducing per-pupil funding differences took some time to achieve; however, significant strides were made in the early years and later through policies that sought to "level up" low-revenue districts. More recently, the elimination of certain supplemental state aid payments to the higher-revenue "hold harmless" school districts (Sec. 20j payments) effectively resulted in further per pupil equity gains. In contrast to the "leveling up" approach, funding equity was achieved by reducing per-pupil funding at the top of the scale when the Sec. 20j payment funding was eliminated by gubernatorial veto.

Another key objective of Proposal A that was made possible through centralizing school finances concerned the implementation of public school academies (charter schools). Charters provided elements of choice and accountability to the traditional education system. Under the old finance model, it was difficult to fund charters because these entities lacked the taxing authority that generated the majority of school operating revenues, (i.e., local property taxes). With state taxes providing the bulk of the revenues and the state government controlling the purse strings, combined with the adoption of a per-pupil model for distributing school revenues, it was much easier for the state to fund charter schools.

Revenue Performance Issues

Michigan's school finance system has both short- and long-term implications for state and local revenue growth and the future potential thereof. In the near term, state revenue will continue to be most directly impacted by the economic activity in the state and the nation. Similarly, property taxes for all entities will be affected by the fall out from the housing market downturn which has, and will continue to, reduce housing values. Short-term revenue performance is also affected by legal or statutory factors, such as state tax policy changes that have current-year and near-term revenue impacts or tax limitation provisions affecting local property tax receipts. It is estimated that the amount of state and local tax revenues available for public education operations in the current year, FY2010, is over $900 million below the level that was available in FY2008.

The sustainability of public education is based on the long-term growth potential of the system that generates essential resources. Over a longer time horizon, growth of both state and local education revenues is determined by structural aspects of the financing system as it currently exists, which can be both economic and legal in nature.

The financing system must also general adequate revenues, both at the individual district level and across the entire public education system. Funding adequacy, at least in an absolute sense, is a very subjective concept because of the inherent differences that exist across the many districts, local and intermediate. Districts are not homogenous and vary in terms of their student characteristics and needs (e.g., high-cost versus low-cost), costs of doing business (e.g., mainly personnel costs), enrollment levels (e.g., both the aggregate level as well as yearly fluctuations), and the environment in which local schools operate (e.g., parental and community involvement and support for education).

Assessments of system-wide adequacy can logically flow from evaluations that examine whether or not district-level adequacy has been achieved. In this sense, it can be reasoned that if adequacy exists within each school district, then the system, as a whole, is funded adequately. Another, and much more simplistic, way to look at system-wide adequacy, at least in the short-term, is to examine changes in resource levels from one year to the next. This approach does not address the longer-term implications or prospects of funding adequacy and ignores the more complex task of defining "adequacy". Regardless of how adequacy is defined, current resources are not adequate to support the spending level from FY2008. Therefore, anyone who is interested in supporting education at the FY 2008 level, or is interested in supporting education at an even higher level, will find the current level of funding inadequate. Those who believe that state spending in FY 2008 was more than adequate, will be more comfortable with the current lower level of revenues.

The 16-year history of operating under the current K-12 revenue structure highlights a host of issues that were not present under the localized revenue system that existed before Proposal A. Further, major economic, demographic, and legal factors, old and new, have influenced revenues in ways not contemplated by the architects of the system. Currently, Michigan public school revenues are being affected by both short- and long-term factors. Understanding the different influences on revenues at both the state and local level is critical to gain an understanding of the nature of the perceived problem at issue as well as to affect corrective changes to the system prospectively.

Near-Term Revenue Volatility

In the near-term, the primary factor influencing the revenue performance of Michigan's school financing system is the broader economy. This is especially relevant for state taxes, which comprise the major-

ity of the funding for education. While the economic downturn of the early 2000s provided the first test of the current financing structure during a business cycle contraction, that experience did not compare to the most recent downturn in either duration or depth. The recent experience can be used to shine light on different characteristics and dimensions of Michigan's school finance system that were previously unobserved. For example, the 2008 recession highlights the acute relationships between changes in economic growth and tax revenues for each individual tax source, as well as the entire school finance system. Evidence of the relationships is most apparent in the performance of personal income and consumption taxes in FY2009 and FY2010.

Tax revenue volatility, in broad terms, refers to fluctuations over time in tax receipts. Although fairly simple in concept, volatility is complex and entails various characteristics. Fluctuations can come in all sizes (modest to steep) and durations (infrequent to frequent). Revenue fluctuations that are of the most interest to policy makers generally relate to those closely related to the business cycle. In this sense, volatility attempts to measure how revenues respond to fluctuations in state economic activity.

Revenue volatility is concerned with changes in the short-term and can be thought of as the inverse of revenue stability, which is more concerned with long-term growth rates. To measure revenue stability, economists compare the *growth* of tax revenues to the *growth* in the economy (usually personal income). Volatility, on the other hand, is measured by comparing the *changes* in the growth rates of revenues and personal income. Generally, studies have found that income tax revenues are more responsive to changes in economic growth than revenues from consumption-based taxes (sales and use taxes in Michigan). These studies find that income tax (personal and business) receipts fluctuate more widely with economic changes than do sales taxes, but the differences are marginal.[20] In contrast, property tax revenues (both state and local) are the least responsive to economic fluctuations.[21] Michigan relies on all three of these taxes to finance public schools.

Over the short-term, estimates of tax revenue sensitivity to the business cycle vary. Corporate income taxes are the most variable followed by personal income, sales (excluding food), sales (including food), and adjusted gross income taxes. Major excise taxes, gasoline and liquor, are the least sensitive to cyclical economic changes.[22] These general relationships are observed in the performance of Michigan state and local school operating taxes relative to state economic activity over the recent recession (See **Table 15**).

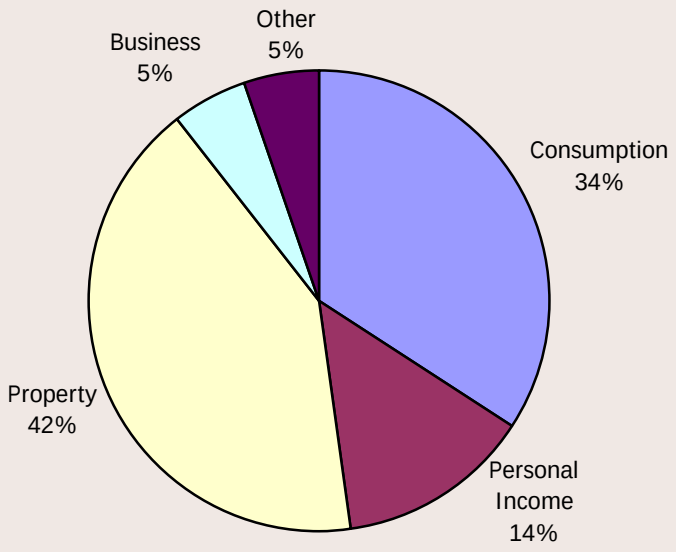
Table 15
State and Local School Operating Taxes and Personal Income
(Dollars in Millions)

Tax	FY2008	FY2009	Percent Change	FY2010*	Percent Change
Consumption Taxes	$ 5,387	$ 4,793	-11.0%	$ 4,866	1.5%
Personal Income Tax	2,118	1,895	-10.5%	1,815	-4.2%
Property Taxes (state and local)	6,064	5,796	-4.4%	5,699	-1.7%
Business Tax	341	729	113.8%	727	-0.3%
Other Taxes	847	739	-12.7%	726	-1.8%
Total Taxes	$ 14,756	$ 13,953	-5.4%	$ 13,832	-0.9%
MI Personal Income	$349,612	$339,219	-3.0%	$343,289	1.2%

* Based on May 2010 Consensus Revenue Estimates

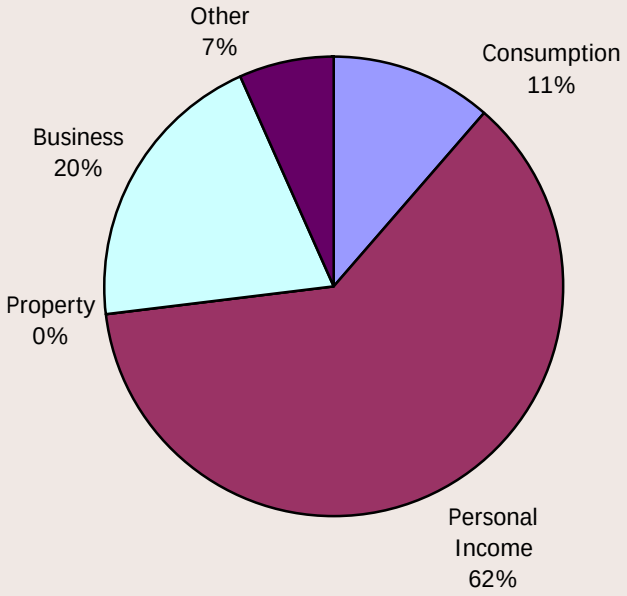
Source: Michigan Department of Treasury; Michigan Department of Education; U.S. Department of Commerce

Chart 21
State and Local Education Operating Taxes by Source: FY2009



Source: Michigan Department of Education; Michigan Department of Treasury

Chart 22
State of Michigan General Fund Taxes by Source: FY2009



Source: Michigan Department of Treasury

Relationships between the business cycle and each tax source help explain the performance of each tax; however, the short-term performance, or volatility, of the overall financing system is determined by the composition of taxes. Stated another way, the degree of revenue volatility facing Michigan schools can be influenced by the mix of major taxes: consumption, property, and income. To provide some context regarding Michigan school finance tax composition, school operating taxes from all sources are compared to the mix of taxes supporting the State of Michigan General Fund (See **Charts 21** and **22**).

The tax revenue volatility observed in Michigan public school finances over the FY2008 to FY2010 period, and reported in **Table 15**, was considerably less than the experience of the General Fund taxes over the same period. In FY2009, baseline state General Fund tax revenues, (adjusted for tax policy changes, such as the income tax rate increase) fell 14 percent compared to a decline of only 5.4 percent in total state and local operating revenues (controlled for tax changes associated with personal property tax exemptions). Michigan's education finance system is less volatile than the General Fund due to the balanced mix of taxes used to support schools and the heavier reliance on property taxes (state and local).

Economists often use the analogy of a "three-legged stool" to describe a balanced public finance system, where each leg of the stool represents one of the major tax categories. Balance in this scenario is achieved when the legs are of roughly equal length. Balance among these three major taxes ensures that a finance system is diversified and relatively broad-based, which ensures that all types of individuals, firms, income, and economic activity share in the burden of financing public services. While balance may not be appropriate if the objective is to ensure the greatest degree of revenue growth during an economic expansion, it can be efficacious to guard against wide swings in revenues during an economic decline by diversifying exposure to different taxpayers and segments of the economy. Tax composition can reduce volatility and help guard against wide fluctuations in public finances in the short-run, but modifying the make-up of taxes in any substantive way is generally a long-term endeavor.

Both on its own, and in comparison to the state's General Fund, Michigan's school funding system exhibits substantial "balance", as no single source dominates the mix by occupying a majority share.

Both on its own, and in comparison to the state's General Fund, Michigan's school funding system exhibits substantial "balance", as no single source dominates the mix by occupying a majority share. The largest single source (42 percent of the total) supporting education is the property tax (state and local), which has been the most consistent and steady revenue source until recently. The General Fund, in contrast, does not receive property tax revenue. From a revenue volatility vantage point, school funding is more heavily weighted towards the two major revenue sources (property and consumption taxes) that are least affected by economic fluctuations. [Note: Income taxes, individual and corporate, are the most sensitive to economic conditions.] Together, property (state and local) and sales and use taxes account for three-fourths of the overall tax picture supporting school operations. In contrast, the most volatile tax source (income tax) makes up over 60 percent of the General Fund picture, but only 14 percent of school revenues. The differences in tax mixes between the General Fund and education funding explain, in part, the variations in volatility over the recent recession.

Revenue volatility is problematic for public financing systems for a number of reasons. The first and most obvious impact of volatility is the large dollar variations that result. Michigan's school finance system grappled with this problem in FY2009 and FY2010, and flat revenue growth estimated for FY2011 suggests that the sharp revenue declines in these two years will not be alleviated immediately. Also, significant swings in the level of resources can lead to problems in fiscal planning and management. Even if large drops in revenue are accurately predicted, which is difficult to do with absolute certainty, managing them can be extremely difficult as public programs, especially education services, are predicated on stable revenue streams. Making short-term corrections in planned spending to address revenue shortfalls is not necessarily an expedient exercise. School costs are largely fixed in the short-term due to the large role played by personnel costs (salaries and fringe benefits). Timing is also affected by the presence of multi-year collective bargaining agreements that control large shares of annual compensation spending in schools.

Responding to Volatility: Potential Options

Revenue volatility arising from an historic recession has diminished the state and local operating revenues available to schools. FY2010 estimated school operating tax receipts (state and local) are projected to be $925 million below the FY2008 level (See **Table 15**). This shortfall has been addressed, at least temporarily, in FY2009 and FY2010 mainly through the use of federal recovery funding available to Michigan, amounting to a little more than $1 billion for the two years combined. Approximately $600 million was used in FY2009 to stave off per-pupil reductions and respond to a 5.4 percent decline in the level of state and local revenues. Despite the use of another $450 million in federal resources in FY2010, a $165 per-pupil reduction in state aid was enacted as part of the state budget. The federal resources will be nearly exhausted by the end of FY2010, leaving less support for education services entering

FY2011. State education taxes are currently projected to grow by less than one percent in FY2011, leaving aggregate school operating support for that year still well below the level experienced in FY2008.

Extraordinary Sources of Revenue

In theory, cyclical fluctuations in revenue can be mitigated through the use of reserves or transfers from other sources. Although sizeable state education tax reserves were built up during the economic expansion of the mid- to late-1990s, they were exhausted to maintain spending levels in some years and to moderate spending reductions in other years following the recession of the early 2000s. Entering the current recession (FY2009 school budget year), the state was not positioned to counteract the downturn in on-going state education resource levels through the use of built-up, dedicated education reserves.

Similarly, the Economic and Budget Stabilization Fund, the state's rainy day fund designed to help smooth declines in state revenue, had amassed $1.3 billion by FY2000, before it was tapped to help support state spending for general operations as well as public education. A $350 million transfer in FY2002 helped address a revenue shortfall in the School Aid Fund. Rainy day fund reserves were effectively exhausted in FY2003, leaving it unable to help with current revenue shortfalls.[23]

While it is technically feasible to divert additional General Fund resources to schools, the policy direction in recent years has been to reduce the general tax subsidy for public education in order to attend to other state budget challenges. In fact, additional actions have taken place to cost-shift items from the General Fund to the School Aid Fund to help achieve budget balance. The annual General Fund subsidy to the School Aid Fund was reduced each year since FY2004, falling from $378 million to its "irreducible minimum" today. Currently, the General Fund pays for those education programs it is required to fund and nothing more. Given the current status of the General Fund budget, increased levels of general tax support for schools appears unlikely.

Local schools may have reserves or fund balances that they have accumulated. The use of fund balances to finance current programs may be a prudent mechanism for managing through short-term fiscal strains brought about by the effects of the business cycle. Experience and access to fund balance reserves vary from school district to school district, which effectively negates using this approach on a statewide basis. Also, there are a number of considerations associated with the use of school district reserves on a widespread basis or over an extended period of time. A statewide professional organization, the Michigan School Business Officials, suggests that key factors in determining the appropriate use of fund balances at the individual district include the unique mix of state and local revenues, tax collection timing in each district, historical use of fund balance and overall trends, near-term future obligations, and trends with respect to student enrollments.[24] This group suggests, based on these considerations and the potential for mid-stream state aid reductions, that an acceptable fund balance for districts to maintain is at least 15 percent of total spending. A recent survey of school districts revealed continued reliance on fund balances to manage through revenue declines, with an aggregate reduction of 32 percent of districts' overall fund balance during FY2010 and a projection that 47 percent of the remaining reserves will be used in FY2011.[25]

The use of fund balances to finance current programs may be a prudent mechanism for managing through short-term fiscal strains brought about by the effects of the business cycle. Experience and access to fund balance reserves vary from school district to school district, which effectively negates using this approach on a statewide basis.

Sustained periods of weak or no-growth in the major on-going revenue sources will quickly exhaust temporary, non-recurring resources or draw them down to minimally-acceptable levels. In an environment of long-term funding uncertainty, schools must be more frugal with their use of fund balance to manage over the short term because future prospects are not bright for restoring these resources to

previous levels. Given the duration of the economic challenges in Michigan, many school districts have been using this mechanism for a number of years already out of necessity. A continuation of the practice is less likely as reserves are exhausted.

Most recently, state revenue volatility has been addressed through use of temporary federal funds provided through the American Recovery and Reinvestment Act (ARRA) of 2009. Prospectively, federal discretionary resources such as ARRA cannot be relied on to help moderate revenue volatility associated with Michigan's school finance system. ARRA resources were provided to the states largely because of the severity of the economic downturn in 2008 and 2009 and its effects on public budgets. Future, year-over-year state revenue declines will have to be managed through cuts or the use of state or local reserves, if such resources exist.

Entering FY2011, increasing taxes is one approach to address the combined state and local revenue reductions that occurred between FY2008 and FY2010. The options available under this approach are limited and largely the province of state policy makers because of the highly centralized nature of the school finance system and the restrictions on local revenue supplementation.

Temporary State Tax Increases

Entering FY2011, increasing taxes is one approach to address the combined state and local revenue reductions that occurred between FY2008 and FY2010. The options available under this approach are limited and largely the province of state policy makers because of the highly centralized nature of the school finance system and the restrictions on local revenue supplementation. An approach based on increasing state tax revenues can follow one of two paths.

The first is an increase in the rate(s) of one or more of the existing taxes dedicated to public education. Such a rate increase might be structured to be temporary in nature and provide for a gradual phase-out as on-going revenue growth accelerates during the expected recovery. The State of Michigan used such temporary tax rate increases to respond to the fiscal challenges resulting from the recession of the 1980s. In 1982 and 1983 the income tax rate was temporarily increased to build up cash reserves and to support on-going spending initially; however, by 1986 the rate was phased down to the original rate in 1981.[26] More recently, cigarette tax increases in 2002 and 2004 were enacted to address revenue shortfalls in the School Aid Fund. While the current governor has proposed a number of revenue responses to address school funding issues, thus far, a legislatively agreeable state response to increase school operating revenues has not been formulated.

The second revenue-centric approach would involve a tax restructuring scenario whereby both rates and bases of current taxes are affected. Generally, states employ tax restructuring to address longer-term policy issues, such as revenue stability and growth issues as opposed to near-term revenue concerns. Restructuring may be employed to "re-balance" the mixture of taxes, which was one objective of Proposal A in 1994. While not the primary goal of tax restructuring, such efforts can be designed to explicitly address near-term revenue concerns as a secondary objective. The near-term revenue impacts can result in increasing, decreasing, or maintaining the current level of resources for schools. The governor's FY2011 budget recommendation contemplated such a scenario, which resulted in a net tax increase in the immediate-term ($554 million), with nearly all the added revenues dedicated to finance schools. Under the proposal, and within three years of its implementation, the governor's recommended new state tax scheme is revenue-neutral.[27]

Local Revenues

Centralization effectively prohibits a local response to state revenue reductions, at least in the near-term. Despite the sizeable and important role that local property tax revenues play in the overall financing scheme for schools, constitutional and statutory provisions effectively fix the rates and bases of these taxes at their current levels, providing little room for local revenue supplementation. Where state law does permit supplementation (i.e., ISD enhance-

ment millages), the mechanism requires up-front costs (e.g., election and outreach) and the amount that can be raised is limited (up to three mills). Furthermore, such a response is difficult to implement in the near-term and over the period in which revenue volatility is most pronounced. Also, the enhancement millage is generally, but not universally, viewed as a fiscal tool designed to "enhance" existing resources over a longer period of time, as opposed to a tool for responding to short-term revenue swings.

School operating taxes, whether for local school districts (e.g., 18-mill non-homestead) or intermediate school districts (e.g., special education), will be adversely affected in the near-term by the declining value of property tax assessments. As noted previously, property assessments and taxable values have been falling throughout the state. This is a phenomenon affecting all types of local government including general purpose (e.g., cities, counties) as well as special purpose (e.g., local schools) entities. The decline in values is expected to accelerate in the near term and become more pervasive statewide, adding to the level of fiscal distress for many local governments.

For local governments with the authority and room under previously-approved tax rate limitations, tax rate increases are an option to manage through the period of declining property tax bases. However, for public school operations, especially local districts, rates are generally fixed in state law and there is no option to address the tax base decline via an increase in property tax rates. Furthermore, because of how the foundation allowance works and the "guaranteed" nature of this per-pupil grant, there would be little incentive at the local level to raise millage rates even if the option were available. With the exception of restoring previous Headlee "roll backs", there is no financial incentive for local districts to raise additional funding locally under the state-controlled foundation allowance.

Unlike local districts that have few options and little incentive to act individually to address declining property tax revenues, intermediate school districts (ISDs) can respond by asking for tax rate increases. Some ISDs will be able to seek millage increases if they have room under existing tax rate caps; however, this will require voter approval, which is not guaranteed. Current and future tax base declines will be directly reflected in school operating levies, both locals and ISDs. Since Proposal A's adoption in 1994, school operating tax levies have consistently exhibited strong, positive growth in annual tax levies; however, for many school districts in Michigan, this experience will cease in the coming years, placing more fiscal pressure on state revenues to maintain current per-pupil revenue guarantees.

Since Proposal A's adoption in 1994, local school operating tax levies have consistently exhibited strong, positive growth in annual tax levies. For many school districts in Michigan, this experience will cease in the coming years.

Long-Term Revenue Issues: Stability and Adequacy

Over the long-run and in an environment of moderate economic growth, such as that envisioned in CRC's 2008 report, *Michigan's Fiscal Future,* cited earlier, the business cycle's effects on state and local school revenues would not be as noticeable and short-term volatility would not be the primary concern surrounding the school financing system. Stability and predictability of the revenue stream, however, will be chief concerns in the future. The stability concerns of today are much different than those of the early 1990s, before the adoption of the current school financing system. Today, the concerns center on the long-term prospects for growth, whereas 20 years ago public education providers had to contend with the prospect that local voters would reject, at the ballot box, local school millages that provided the majority of operating funds. While Proposal A did provide some stability in the form of a baseline level of resources, it did nothing explicitly to address the future growth of these resources. Entering a period of economic recovery following the Great Recession, a closer examination of the growth potential in school finance is warranted.

In addition to stability and predictability, many education reformers and policy makers have suggested that public education finance systems should produce a level of resources each year to educate children that can be deemed "adequate". While a universal definition of "adequacy" has not been developed, a number of states have been able, through various methods (e.g., "cost out" studies), to satisfy state-specific legal definitions of the term.[28] In some states, legislatures or executive branch entities, have taken steps to define what is included in an "adequate" education.

"Adequacy" lawsuits in other states generally have been based on language in state constitutions that suggests a certain quality of education, e.g. "thorough", "efficient", or "uniform". The Michigan Constitution does not prescribe a certain quality level for Michigan schools, but instead defers to the legislature to "maintain and support a system of free public elementary and secondary schools as defined by law." (Article VIII, Section 2) Clearly, the Michigan Legislature is tasked with providing a free education to Michigan children; however, the quality of education is not addressed in the state's basic law. To date, Michigan has not been vulnerable to legal challenges to its school finance system based on "adequacy" claims. Absent clear legal language (constitutional or statutory) to help define what is meant by an "adequate" education in Michigan, and because of the highly subjective nature of the term and other related concepts, it is very unlikely that the school finance system will be found to be "inadequate".

This report does not endeavor to fully explore the concept of educational adequacy, but rather to highlight the relationship between the term and other desired characteristics of a school finance model, namely stability. Regardless of how the term "adequacy" is defined in Michigan, a school finance system that results in stable and predictable revenue growth will help promote an adequate level of resources each year. This is not to suggest that a stable and predictable school finance system in Michigan will automatically result in one that is adequate. At the same time, it is difficult to envision how an adequate finance system, once the term is defined, can be premised on something other than a stable revenue base.

Revenue stability is often a desired objective of public finance because of the relatively predictable and consistent nature of the demand for public services over time as well as the predictable nature of spending.

Why Stability?

Revenue stability is often a desired objective of public finance because of the relatively predictable and consistent nature of the demand for public services over time as well as the predictable nature of spending. Unlike the demand for private goods and services which tends to ebb and flow with market forces, the demand for public services is generally the same from one year to the next. Demand for public services is also largely unaffected by economic recessions. Unlike the private sector where consumer demand for goods and services often diminishes with the downturn in the business cycle, citizens continue to demand basic public services from government regardless of the condition of the underlying economic base upon which the services are financed. The demand for government services is largely driven by factors disconnected from changes in the business cycle. In some cases, services provided by government are "countercyclical" in nature. This means that when the business cycle sours, demand for a program, and therefore employment in that program, rises (e.g., unemployment insurance, job training). Demand for higher education, especially at the community college level, tends to rise with a slowdown in economic activity. Individuals return to school to seek new skills and job re-training for future employment opportunities when the economy rebounds.

The difference between public and private entities suggests that a greater level of revenue stability is desired in public finance systems. For example, the demand for basic public elementary and secondary education services (measured by the number of children in the system) is generally consistent and tends to exhibit gradual rather than abrupt changes over time.

The nature and scope of public spending also help explain the need for stability in on-going revenues. Generally, the services provided by governments are labor intensive, and prices can be considered "sticky", at least in the short-run. Schools, for example, have continuing long-term salary and other compensation liabilities that comprise upwards of 80 percent of total operating expenses. Furthermore, public budgets are developed and adopted months before actual revenues are known and elected officials make spending decisions on expected revenue growth. Thus, greater degrees of revenue stability and predictability help to avoid the task of having to make major fiscal adjustments over short periods of time.

Revenue stability is also an important characteristic for public finance systems at the sub-federal level because, unlike the federal government, states and localities must adhere to strict balanced budget requirements. Operating in an environment where revenues fluctuate wildly and annual levels can be unpredictable, public entities must respond by cutting services or increasing tax rates, options which are generally unpopular. Government budgets are based on assumptions of predictable and steady growth.

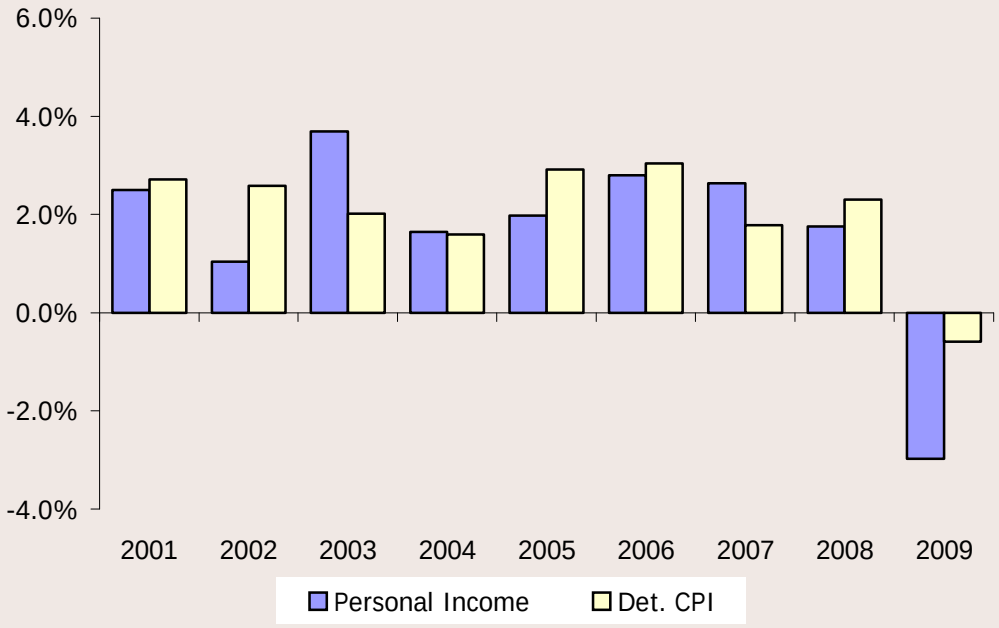
Revenue stability can be thought of in terms of a long-term trend line, with specific attention to the direction (e.g., increasing or decreasing) and the annual rate of change of the line (e.g., slow, moderate, etc.). Revenue stability is a relative, not an absolute, term. As such, changes in revenue are often compared to changes in other measures. Two common, but distinct, ways to look at revenue stability include, 1) comparing the growth in the resource level with growth in the overall economy, and 2) comparing revenue growth with the growth in costs associated with providing education services. Both metrics carry with them inherent advantages and disadvantages.

Tying long-term revenue growth to changes in economic growth is appealing because this measure relates directly to taxpayers' (individuals and firms) ability to pay. Increases in economic growth, as measured by personal income, suggest a greater ability to pay over time, while decreases intimate the opposite.

Tying long-term revenue growth to changes in economic growth is appealing because this measure relates directly to taxpayers' (individuals and firms) ability to pay. Increases in economic growth, as measured by personal income, suggest a greater ability to pay over time, while decreases intimate the opposite. Linking the two has the advantage of reducing the frequency that elected officials have to raise tax rates to ensure a desired rate of revenue growth. In theory, and assuming all else constant, if the tax base grows in concert with economic activity in the state, tax rates will not have to be adjusted to ensure stable revenue growth.

A second perspective on revenue stability acknowledges that the costs of providing public education services do not, necessarily, ebb and flow with the ups and downs of the broader economy. Under such a scenario, it is argued that revenue growth should keep pace with the increases in cost pressures that underlie education spending. Education spending is largely concentrated in personnel costs, the growth of which do not directly track overall changes in state economic activity. Because compensation costs are influenced by a host of factors not directly related to the economy, a better measure for revenue growth might be inflation. A common measure, the Consumer Price Index (CPI), tracks the average price of goods and services purchased by households. Although generally acknowledged as an approximate measure of inflation, it is worth noting that the service mix included in the CPI is not the same as the mix of public education services. Although there are several other price indices, including ones that may be more appropriate to the factors that drive education spending, this report defers to the most common metric of price inflation and the one that is most readily available.

Chart 23
Annual Changes in Michigan Personal Income and Detroit Consumer Price Index: 2001 to 2009



Source: U.S. Department of Commerce; U.S. Department of Labor

Annual changes in Michigan economic activity, as measured by personal income, and inflation, as measured by the Detroit CPI, for the last eight years are reflected in **Chart 23.** In both cases this period was marked by low annual growth rates. Prior to the declines in both measures that occurred in 2009, from 2000 through 2008, the annualized growth rates for personal income and inflation were 2.2 percent and 2.3 percent, respectively. These growth rates are below those historically observed in Michigan. Also, the recent period is unique in that inflation has very slightly out-paced economic growth, something that, if continued over the long-run, portends serious problems for the state as it indicates the state will continually become poorer. Over a much longer timeframe in Michigan (1970 to 2008), annual personal income growth (5.8 percent per year) outpaced changes in the Detroit CPI (4.3 percent per year). A return to the longer-term relationship (i.e., economic growth exceed inflation) can be expected prospectively.'

A stable education finance system is one that provides long-term revenue growth that approximates economic growth. Over the short term, as evidenced in **Chart 23**, personal income is more volatile than inflation which some might view as a disadvantage; however, over the long-run, economic growth provides a greater level of growth potential and therefore stability. Also, as a benchmark for revenue growth, economic growth ties directly to a state's ability to finance public education services, something a price index, such as the CPI, does not.

Prospects for Long-Term Revenue Stability

The connection between Michigan's economy and the state government's tax structure has weakened since the late 1990s, a trend which is expected to continue if corrective tax modification actions are not taken. The long-term challenges affecting state and local education revenues are rooted in these weakening connections as well as in state tax limitations (i.e., primarily dealing with property taxation) that accompanied Proposal A's passage and those that pre-date Proposal A. Solutions to the long-term revenue stability challenges that plague education finance will require attention to the structural components of Michigan's school finance system. While an improved economic climate will increase state revenue levels above where they have been recently, the underlying relationship between tax receipts and the economy will be unaffected by the economic recovery. Future growth will be determined by these relationships. It is not the goal of this analysis to assess whether public education spending is too high or too low in the current and near-term environment. Such a question is ultimately political in nature and under the purview of elected policy makers. Instead, the objective here is to highlight whether or not the system of education financing, as it currently exists, is capable of generating a level of on-going revenue that grows with the economy over the long run.

Structural factors have caused state tax revenues to lag behind general measures of economic activity, a problem not unique to state education taxes. These factors also affect the state's General Fund budget, which further exacerbates the stability concerns surrounding education funding problems. Earlier in this report, state-dedicated education revenues were examined in depth and it was clearly illustrated that from FY2001 through FY2008, measures of economic activity in Michigan outpaced the growth in personal income tax revenues, sales and use tax revenues, and other minor tax revenues, all of which play key roles in Michigan's school finance model (summarized again in **Table 16**).

The prospects for long-term revenue stability in Michigan education finances will depend on the relationships between the financing system and the underlying economy (i.e., the system's various tax bases). Regardless of the type of tax or the level of government responsible for levying it (e.g., property taxes are levied at both the state and local levels), these

Table 16
Changes in Broad Economic Measures and SAF Tax Revenues: FY2001 to FY2008
(Dollars in Millions)

	FY2001	FY2008	Percent Change	Annual Rate
Tax Revenues				
Sales and Use Taxes	$5,076	$5,387	6.1%	0.9%
Personal Income Tax	1,955	2,118	8.3%	1.1%
State Education Tax*	1,490	2,153	44.5%	5.4%
Other Minor Taxes*	886	896	1.1%	0.2%
Personal Income	$299,903	$349,612	16.7%	2.2%
Real Personal Income**	$171,963	$170,752	(0.7%)	(0.1%)

* Adjustments were made to the FY2008 figures to account for the Michigan Business Tax and personal property tax changes that affected receipts in FY2008 to allow for comparison across years.

** Income deflated by Detroit CPI (1982-84 dollars)

Sources: Bureau of Economic Analysis; Michigan Department of Education; CRC calculations.

relationships will play the most important role in determining the annual resources available to schools each year. The intricacies of the relationships vary depending on the individual tax instrument. Although this report concentrates on these relationships during a period of very low economic growth in the state (2001 to 2008) and during a very severe recession (2009 and 2010), it is expected that, prospectively and over the longer-term, the relationships between the major taxes supporting schools and the Michigan economy will continue to weaken despite improvements in the economy in the near-term and a return to the historical relationship between economic growth and inflation.

Emerging from this most recent period, Michigan economic activity is not expected to approach the long-term trend line, but it is likely that growth will exceed the recent dismal experience. From 1970 to 2008 Michigan's real personal income grew at an annualized rate of 1.6 percent, compared to a decline of 0.1 percent in the recent period (2001 to 2008). Prospectively over the near-term, real state economic growth is not likely to approach the experience between 1970 and 2008; however, it is also cannot remain in the negative territory for too long because of the serious financial implications to the state's residents and public service providers. In real terms, a return to positive economic growth is expected.

The further weakening of the relationships observed between state economic activity and state tax receipts can be understood by examining experiences to date. Broadly defined and categorized, the mismatch between economic growth and tax revenue growth observed since the adoption Proposal A is explained by three primary factors. The most observable explanatory factor includes policy changes that targeted the rates and/or bases of the major SAF taxes. Examples include adopted reductions to the sales and use tax bases. The second primary factor, which is not nearly as noticeable as direct tax policy modifications, relates to gradual shifts in consumer behavior over time. In general, the shifts in behavior pertain to general questions such as "What is being consumed today compared to the past?" and "How are consumers making purchases today compared to the past?" Finally, a third contributing factor to the slow-growth in state-level education tax receipts, at least relative to the economy, is explained by changes in Michigan's demographic make-up. Specifically, the aging of Michigan residents and the tax treatment of these individuals has acted to constrain the growth of dedicated education revenues, which is expected to continue.

Policy actions that either directly or indirectly affect the rates or bases of state education taxes are responsible for the observed mismatch between changes in economic activity and earmarked tax revenues of the School Aid Fund.

Tax Policy

Policy actions that either directly or indirectly affect the rates or bases of state education taxes are responsible for the observed mismatch between changes in economic activity and earmarked tax revenues of the School Aid Fund. Tax policy changes are not limited to the most recent time period, but can be viewed over the longer 16-year period since Proposal A. Policy changes have the dual effect of reducing the annual tax revenue growth rate, as well as reducing the level of receipts following policy implementation. In some cases, as with the individual income tax rate reductions that began in 1999, policy makers included provisions to shield school funding from the immediate revenue losses associated with the policy change. This change did not affect the long-term relationship between the income tax and future growth potential of SAF-earmarked income tax receipts. More recently, state efforts to reform business taxation in Michigan resulted in the elimination of certain personal property from the base of taxation, both for state and local property taxes dedicated to schools. Safeguards were included in this effort to protect education funding from the revenue loss that would occur at both the local and state level by earmarking a portion of the new Michigan Business Tax (MBT) to the SAF. In this instance, the immediate fiscal impact for schools was neutral; however, future growth of the new MBT earmark was tied to growth in the inflation rate which has

the potential to grow at a faster rate than the value of personal property (i.e., the previous tax base). Clearly, any overt legislative action that results in lowering the rate or shrinking the base of one or more of the SAF taxes will have a deleterious effect on overall tax receipts. Furthermore, such actions also have the potential to affect the future growth potential of the Fund.

One approach to examine the effects of tax policy changes on state revenue collections at the macro level is to look at changes in the bases of major taxes over time. Shrinking the tax base of a major tax will depress the growth potential of the tax if base exemptions, as a percentage of overall economic activity, grow at a rate that exceeds the base subject to taxation. In such cases, tax revenues will trail economic growth, unless tax rates are adjusted regularly to account for the "lost" revenue. The Michigan Department of Treasury provides the information to examine such tax base changes. Annually, as part of the executive budget submittal, Treasury issues a report documenting the tax revenue foregone as a result of preferential provisions such as credits, deductions, exemptions, deferrals, exclusions, or preferential tax rates.[29] These tax provisions are collectively referred to as tax expenditures. These tax provisions can be viewed as spending because they target specific public programs; however, unlike direct state spending, it is a form of indirect state spending that occurs through the state's tax code. Unlike direct spending which is authorized via the appropriations process, tax expenditures do not, as a general rule, undergo annual scrutiny in the budget process. Tax expenditures, in some cases, are subject to legislative review as a result of sunset provisions or required reporting. Tax rate reductions do not qualify as tax expenditures and the reported data do not attempt to discern the impact on different state funds, e.g., General Fund, School Aid Fund, etc.

While tax expenditures, such as the treatment of services, represent substantial levels of economic activity that are not captured in the state's tax system, their use and justification must be considered in a broader context.

The most recent report, published in 2010, estimates the lost state and local tax revenue for FY2010 at $36.4 billion. Over 90 percent of the tax expenditures for the year result from policies affecting the three major tax categories: consumption, individual income, and property taxes. Each major tax is affected differently by the mix of credits, exemptions, and deductions. Sales and use taxes account for nearly all of the tax expenditures within the consumption tax category (i.e., general and selective taxes) and the single largest item is the statutory exemption of services from the tax base. For the individual income tax, adjustments to income account for the largest tax expenditure and within this item, retirement and pension income make up the majority. Property tax expenditures are largely attributable to the homestead property tax exemption, a key component of Proposal A property tax relief.

The growth in the aggregate level of tax expenditures reported by Treasury over time has been substantial. Examining the period FY2000 to FY2010 reveals that the total cost of these items grew 78 percent, from $20.4 billion to $36.4 billion. One item that receives considerable attention with respect to school finance matters relates to the treatment of services consumption in the sales and use tax bases. This item accounted for a major piece of the overall growth in the tax expenditure picture during the 10-year timeframe. Tax expenditures in this area more than doubled from $4.3 billion in FY2000 to $10.1 billion in FY2010. Over the same period, sales and use tax revenues, in the aggregate, are expected to *decline* by nearly $475 million. Because of the earmarking provisions associated with sales and use taxes, the growth of the consumption tax base is important to discussions about the future potential growth in education funding. While tax expenditures, such as the treatment of services, represent substantial levels of economic activity that are not captured in the state's tax system, their use and justification must be considered in a broader context. Including some items, such as health services, in the tax base will result in a growth rate that approximate changes in

economic activity; however, there are a number of issues that accompany any such change.

In 2002, a detailed report commissioned by a group of statewide associations representing school administrators and school boards quantified the impact of specific state tax policy changes on Michigan education finances, state and local, since the adoption of Proposal A.[30] The report concluded that newly initiated, post-Proposal A tax changes (primarily involving reductions to tax bases) had major impacts on both local and state-dedicated education funding. It estimated the combined effect on education revenues resulting from all tax changes dealing with the individual income tax, consumption taxes (sales and use), state and local property taxes, economic incentives, and other taxes. In nominal terms, for FY2002 alone, the projected revenue loss to state and local K-12 finances was $550 million. And, since Proposal A, these changes had accumulated to $2 billion. Nothing has been done in a comprehensive manner to update or replicate the findings of the report; however, it is reasonable to assume that the annual impact on education funding estimated for FY2002 has not declined.

While this report did quantify the revenue impacts from such changes, noting that some policies included provisions to shield education finances from adverse fiscal effects (e.g., income tax rate reductions and renaissance zone exemptions), it did not attempt to quantify the effects that these policies had on the growth rates of the state or local taxes. Commenting on the prospective effects of the various policies identified, the 2002 report concluded that many of the changes, by themselves, do little to affect the overall potential for growth. However, the accumulation of numerous minor modifications to the state's tax code "can dramatically reduce the growth potential of the earmarked taxes over time by eliminating items entirely from the base of a tax or by limiting the base included for taxation."

The 2002 study also pointed out that the fiscal effects of tax changes on education funding, whether direct or indirect, must be understood in the broader context of what constitutes "good" tax policy. For example, many argue that Michigan's provisions that index the personal exemption available under the income tax to inflation, although negatively affecting General Fund and School Aid Fund receipts, represent a "good" tax policy on the grounds that they preserve the value of the exemptions and safeguard them against erosion over time. Taken individually, many of the changes (explicit or implicit) implemented since Proposal A meet the general standards of fairness and equity and therefore constitute "good" tax policy on those grounds. However, in an age of declining public resources for K-12 education and given their cumulative impact on the resources available, additional attention should be given to the tenets of "good" tax policy related to adequacy and sufficiency. Prospectively, the report concludes, that contemplated changes to the state's tax code should be evaluated using the full spectrum of criteria associated with "good" tax policy: equity, stability, and adequacy.

Changing Consumer Behavior

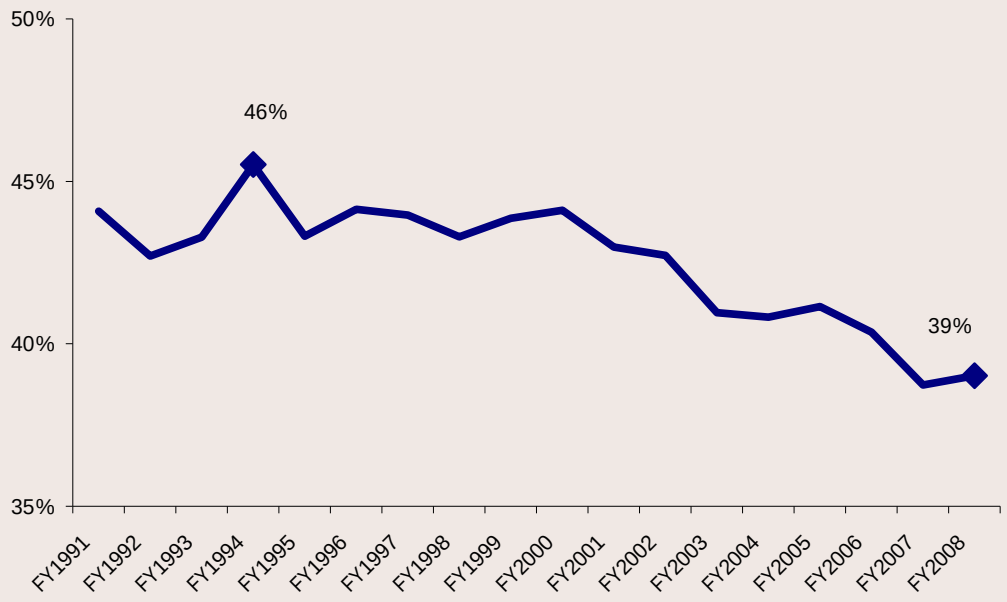
In addition to changes in Michigan's tax code, growth in annual state revenues is affected by changes in consumption patterns. These changes concern two distinct questions, "What is being consumed?" and "How is consumption occurring?" With respect to the first question, today, consumers are purchasing relatively more services and fewer goods. Stated another way, the services sector is the area of fastest growth in the economy. Michigan is not uniquely affected by this change nor is this a recent phenomenon. The shift to a "service preference" represents a longer-term trend occurring throughout the United States. In Michigan, however, the shift in consumer behavior effectively creates a mismatch between what is going on in the economy and the tax receipts generated from the economic activity. Michigan does not apply direct consumption taxes to many services, opting instead to rely most heavily on tangible goods purchases to determine overall sales and use tax revenues.[31] The shift in consumer preferences coupled with Michigan's current tax structure will further exacerbate the mismatch between the growth in tax receipts (consumption taxes) and economic activity (personal income).

The combination of this longer-term trend with Michigan's current tax structure creates a unique fiscal challenge for school finances because of the significant earmarking of consumption taxes to the School Aid Fund (73 percent of sales tax receipts and 33 percent of use tax receipts). The gradual shift in consumer preferences is evident in the decline in the share of total economic activity subject to consumption taxes in Michigan. To highlight the possible fiscal effect of this shift in consumer behavior on state tax collections, consider the data presented in **Chart 24**. Assuming that the mix of taxable/exempt sales in FY1994 were applied to current personal income data for 2008, the SAF revenue from state consumption taxes would have been $900 million greater in FY2008.

The gradual shift in consumer preferences is evident in the decline in the share of total economic activity subject to consumption taxes in Michigan.

The migration towards greater consumption of services vis-à-vis durable goods is observed in the changes in wages over time, by major industry. Total wages constitute about 70 percent of Michigan's personal income and provide a glimpse of where economic activity in the state is taking place.

Chart 24
Taxable Sales as Percent of Personal Income: FY1991 to FY2008

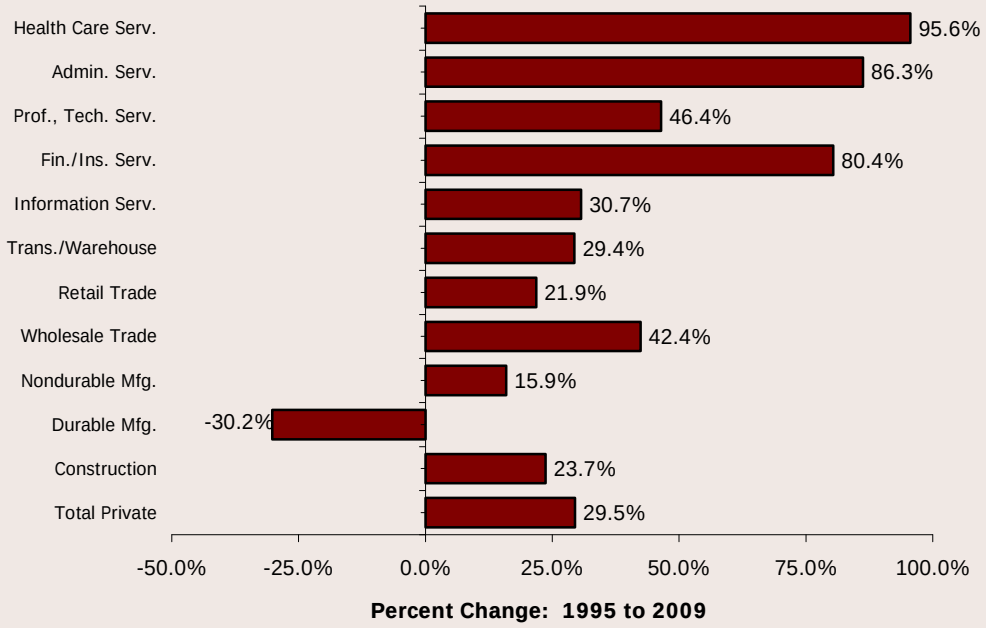


Source: State of Michigan, Comprehensive Annual Financial Reports; U.S. Department of Commerce

Between 1995 and 2009, the state's service sector (e.g., health care, administrative, professional and technical, financial and insurance) grew well in excess of its manufacturing sector (durable and nondurable goods) (**Chart 25**). Wage earnings in the health care services sector grew over three times (96 percent) as much as total private sector wages (30 percent) during the period. As a result of the disparate wage growth across industries, the service sector occupies a larger share of the overall economy and the goods-producing sector a relatively smaller portion. Although not reflected in the chart here, data for the period shows that manufacturing comprised 32 percent of total private wage earnings in 1995 and declined to 19 percent in 2009, while the health care services sector grew from 10 percent to 16 percent of total wages over the same period. During the 1995 to 2009 period, Michigan's tax structure remained unchanged relative to the compositional adjustments in the economy.

Shifting consumer preferences relative to "how" consumption occurs also constrains revenue growth for schools. The growth in consumption tax revenue is largely dependent on tangible goods purchases from businesses located in Michigan because the state lacks an effective way to collect use tax on tangible goods purchased from sellers outside of the state. Remote and Internet sales are expanding more rapidly than traditional "brick and mortar" store sales. As a result, the sales and use tax bases in Michigan are being slowly eroded by the increase in remote sales, which is contributing to the slide observed in **Chart 24**. Because the State of Michigan lacks authority to require firms that do not have nexus in the state to collect sales taxes on purchases made by consumers in this state, a significant and increasing amount of economic activity each year escapes taxation.[32] The issue relates to the commerce clause of the U.S. Constitution and Michigan lawmakers lack the power to craft a state-specific response to this issue.

Chart 25
Wage Earnings Growth by Private Sector Industry: 1995 to 2009



Source: U.S. Department of Commerce

The inability to effectively tax remote sales activity inhibits the growth potential of SAF revenues. A recent report by the Michigan Department of Treasury estimates that the sales and use tax revenue loss associated with consumer remote sales in Michigan was $308 million in FY2008 and was expected to grow to $355 million by FY2011.[33] These figures represent the aggregate revenue impact; however, because the SAF receives the largest distribution of combined sales and use taxes, it would experience the majority of the revenue gain if this activity were subject to direct taxation.

Aging of Michigan's Population

Michigan's demographic makeup also explains some of the disconnect between tax receipt growth and economic growth observed over the last 10 years. Quite simply, the state is getting older, proportionately, and the state's tax structure tends to treat its older residents more favorably than its younger residents. This is the case with respect to the individual income tax when exemptions, adjustments, and credits are viewed through an age-specific lens. Also, because the purchasing preferences of older residents are somewhat different than their younger counterparts and given the structure of the sales and use taxes, consumption taxes tend to fall more heavily on younger residents. Assuming no changes in state tax policy with respect to "senior preferences" or modifications to the consumption tax base, a continuation of the aging trend observed over the past decade will further constrain revenue growth for schools.

Although Michigan's total population figure has barely moved from the start of the last decade (an expected increase of less than one-half of one percent), the composition has changed markedly. While the overall population is the same, Michigan's senior population (65 years old and over) grew over seven percent since 2000, thus comprising a larger share of the total population in 2009 (13 percent compared to 12 percent). Across the U.S., the senior population also increased since the beginning of the decade (13 percent); however, the total figure also increased such that this cohort represents roughly the same percentage of the total today as it did nearly ten years ago (about 12 percent). Demographic projections call for the 65 and over cohort in Michigan to continue to grow in nominal terms and as a percent of the total population for the foreseeable future.[34] As a result, the over-65 age group is expected to constitute 17 percent of the state's population in 2017, up from 13 percent today.

From a public finance perspective, the aging of Michigan's population poses serious threats to the potential to provide stable funding for education services in the future. Michigan's income tax currently provides special treatment for residents 65 years old and over, including full exemption of social security income and all public pension income, along with an additional special exemption for seniors ($2,300-single in 2009) on top of the standard personal exemption ($3,600-single in 2009). For private pensioners, a very generous exemption is provided ($45,120-single and $90,240-married in 2009). Seniors also benefit from a number of special credits (e.g., homestead property tax, home heating, and renters' tax). As more and more residents qualify for income tax exemptions, the base of the income tax is further depleted, which negatively affects the growth rate. The School Aid Fund is directly impacted by reductions in the gross collections resulting from the tax base narrowing; however, current law holds the Fund harmless from the fiscal effects of the various senior-specific income tax credits. Credits reduce the level of revenue available to the General Fund and, therefore, its ability to supplement dedicated education revenues.

According to a 2006 report by the Center on Budget and Policy Priorities citing previous research conducted on the topic, Michigan led all states with the most-generous income tax preferences when the effective income tax rates for elderly and non-elderly residents were compared for each state. Within the Great Lakes region, Michigan preferences were nearly double those of the other states.[35] It was estimated that the difference between the effective tax rates of elderly and non-elderly individuals earning less than $200,000 was 2.17 percentage points in Michigan compared to 0.64 percentage points for the nation as a whole. Regionally, the closest state to Michigan was Wisconsin, which had a difference of 1.1 percentage points between the effective income tax rates for the two groups.

Conclusions and Options

Realigning Education Finances with the Michigan Economy: Enhancing Long-Term Stability

While Michigan's school finance system underwent a major transformation in the mid-1990s, the state tax structure upon which the system is based largely resembles what existed 40 years ago. The state's economy has evolved considerably over the last 40-year period and has experienced monumental changes associated with the state's manufacturing base during the last decade. The state's economy will continue to evolve with the attraction and development of new industries and changes in consumer preferences. As a result of current tax policy, major sources of state taxes increasingly do not respond to growth in the overall economy. Re-connecting the weakened relationship between the state's financing structure and the overall economy will require restructuring Michigan's consumption and income taxes. Without state revenue restructuring, the delivery of public education services will have to be re-calibrated to match a revenue system that grows more slowly in the future, because the option to influence overall revenue growth via the local property tax is extremely constrained.

The stability of state revenues would be enhanced if major components of the service-based economy, particularly consumer services, were folded into the base of Michigan's consumption taxes.

In addition to repairing and restoring a stronger relationship between education revenues and the broader economy, policy makers might consider the various, and complex, relationships between the property tax and property tax limitations contained in Michigan's Constitution and state laws. These interactions will prevent education revenues from fully benefiting from future investment and growth in real property. Attention to major tax sources (consumption, income, and property) is prudent, but consideration also should be directed at those minor sources that provide schools with, proportionately fewer, but still very essential, resources.

Sales and Use Taxes

Michigan's consumption-based taxes (sales and use) represent the single largest state source of financing for public schools. The base of these taxes is almost entirely the sale and use of tangible property, with a limited number of services subject to taxation. With the continued shift away from the consumption of goods toward more and more services, the growth in tax yields are expected to continue to lag growth in the economy. While the sales tax rate was increased with the adoption of Proposal A, there has been virtually nothing done to expand the tax base. Further rate increases would provide additional revenue, but Michigan already has the seventh highest sales tax rate of the 45 states levying the tax according to the Federation of Tax Administrators.[36] Raising the rate might place Michigan businesses at a competitive disadvantage. The stability of state revenues would be enhanced if major components of the service-based economy, particularly consumer services, were folded into the base of Michigan's consumption taxes.

In the national perspective, Michigan is somewhat of an outlier in terms of service taxation. According to the Federation of Tax Administrators, Michigan taxes 26 of a possible 168 services identified, placing it in the bottom 25th percentile of states.[37] Within a regional perspective, only Illinois (24 services) and Indiana (17 services) tax fewer services than Michigan.

The effect on the tax base of including all services would be substantial because the dollar value of services not taxed exceeds the value of goods and services currently taxed. A reconstituted tax base with a significant services component would grow

faster than the current sales and use tax bases, however, the final selection of services to include in the tax base will ultimately determine the growth potential. Certain service sectors, such as medical services, are expected to experience faster growth rates than other sectors. Exclusion of higher-growth sectors from the tax base would affect the potential for growth in the future. Adding services to the current tax base can provide an opportunity to reduce the current tax rate by some amount and provide a revenue-neutral starting point. The failed 2007 attempt to include certain services in the consumption tax base highlighted the sensitive nature of expanding the sales tax to services and determining which services to tax.

Economic research on the topic of expanding the sales tax base confirms that adding services to the mix will result in tax revenue growth that more closely tracks economic growth.

A tax restructuring plan that includes consumer services in the sales tax base can be fashioned in a way that increases revenues, decreases revenues, or results in no net change upon implementation.

A broad-based consumption tax is likely to enhance revenue stability and preserve the long-term sales tax yield. It would also provide some protection during recessionary periods against wide fluctuations in revenue that occur as a result of a goods-dominated tax. Michigan's experience over the 2008 recession (e.g., sales tax falling 10 percent in FY2009) is evidence of the volatility of the current tax base. Currently, Michigan's sales tax base is heavily reliant on the purchase of "big ticket" items (e.g., autos, appliances, and furniture), the consumption of which declines sharply during an economic downturn. The consumption of services does not fall as precipitously during a recession. On the flip side, during periods of economic growth and expansion, the stability of service consumption will act to temper the revenue spikes that occur when "big ticket" purchases are made.

Economic research on the topic of expanding the sales tax base confirms that adding services to the mix will result in tax revenue growth that more closely tracks economic growth. A 2006 study that examined state tax activity from 1970 to 1999 found that states with broader sales tax bases (i.e., included services) had higher sales tax elasticities, meaning that growth in sales tax revenues more closely approximated growth in the state economies.[38]

In 2008, CRC estimated the future revenue growth potential of a hypothetical sales tax base that included all services with the exception of business-to-business transactions.[39] This exercise resulted in a much broader sales tax base than that included in Michigan's short-lived 2007 experiment with a services tax. Also, the enhanced tax base assumed in CRC's 2008 report was much broader than the tax base contemplated in Governor Granholm's 2010 service tax proposal, which also called for a 0.5 percentage point rate reduction. The hypothetical tax base developed by CRC included health care services, a large and growing sector of the services field, whereas both the 2007 tax base expansion and the Governor's recent proposal excluded this segment. As noted earlier in the discussion of tax expenditures, the health care sector has grown substantially since the adoption of Proposal A. As previously indicated, wage earnings for the sector in Michigan nearly doubled (96 percent) from 1995 to 2009, compared to 30 percent growth for the entire private sector.

The scenario developed by CRC produced a service tax base equal in size to about two-thirds of the current-law tax base, largely because of the inclusion of health care. As a result of the substantial widening of the base, a sizeable rate reduction (from 6 percent to 3.6 percent) was necessary to produce a "revenue neutral" starting point. The new, re-constituted tax base increased the projected annual sales tax growth rate by 0.8 percentage points, prospectively. A re-structuring plan that couples a broader sales tax base with a reduced rate complies with an oft-cited principle in tax policy that favors taxes that have the widest bases and lowest rates possible.

While in concept there may be considerable support and justification to adopt a broad-based sales tax in

Michigan that includes most, if not all, consumer services, re-configuring the tax base entails a host of complex issues that demand attention before tax restructuring is implemented. In general, administrative cost considerations (both for taxpayers and state government), equity (horizontal and vertical), definitional issues (e.g., what constitutes a service?), economic principles (e.g., how are markets affected?), and administrative matters would have to be addressed. Nationally, the move to greater services taxation is occurring gradually and major state attempts to fold services into the sales tax base have not garnered much success.[40]

Over the long run, growth in consumption taxes will also be affected by the broad shift how Michigan residents make purchases. The explosion in the amount of Internet and other remote sales that escape state consumption taxation is not a recent phenomenon uniquely affecting Michigan. Rather, this represents a shift in consumer behavior that has been going on for some time and impacts all levels of government with authority to collect consumption taxes on the sale of goods. In Michigan, as in other states, efforts have been progressing for a number of years to capture consumption taxes (use tax) from remote sellers to Michigan residents. Thus far, the state's only viable response has been the development of and participation in a voluntary system involving businesses outside of Michigan transacting with Michigan residents. Although purchasers are liable for use tax on Internet and "remote sales", full compliance in this voluntary system has not been realized. It is unlikely that the Internet and "remote sales" economic activity will be folded into the activity that is subject to consumption taxation in Michigan to the fullest extent possible without further action by the U.S. Congress.

The total level of General Fund resources available each year is one factor used by the legislature in determining the ability to supplement dedicated state resources to support public elementary and secondary education services. Therefore, the structural factors affecting the growth in personal income tax receipts affect the stability of education finances over the long-run.

Income Tax

The annual growth of personal income tax receipts plays a major role in the financing of public education, directly and indirectly. Through state tax earmarking provisions, these resources currently represent the third largest component of the School Aid Fund, behind the sales tax and the 6-mill state property tax, and are expected to grow to be the second largest source as state property tax revenues decline over the next couple years. In addition, income tax revenues are the single largest component of the General Fund. As previously noted, the total level of General Fund resources available each year is one factor used by the legislature in determining the ability to supplement dedicated state resources to support public elementary and secondary education services. Therefore, the structural factors affecting the growth in personal income tax receipts affect the stability of education finances over the long-run.

Growth in Michigan personal income tax receipts dedicated to the School Aid Fund has trailed personal income growth since the early 2000s. Similarly, growth in General Fund income tax receipts has fallen behind income growth, but to a greater degree due in part to the weak connections between the tax and the economy, and also as a result of rate reductions and growth in credits. The General Fund was disproportionately affected by the income tax rate reductions phased-in over a period of years in the late 1990s and early 2000s. The School Aid Fund was insulated from these rate reductions through provisions in state law. Ignoring the tax rate changes currently scheduled for the individual income tax, the underlying growth potential of baseline income tax receipts is contingent on the interaction of deductions, exemptions, and credits. Changing the projected growth pattern of income tax receipts in a material way will entail a modification to one or more of these income tax components.

Michigan's personal income tax has proven less responsive to economic changes than the income taxes levied by other states. Enhancing the responsiveness is a complex endeavor and can take a number of approaches. A major structural difference between Michigan's income tax and those of other states is the current constitutional prohibition (Article IX, Section 7) on graduated rates. Michigan is one of seven states that use a flat rate structure, while thirty-four other states levy a broad-based personal income tax using a graduated-rate structure. [Note: Seven states do not levy an income tax and two states levy the tax only on dividends and interest income.] The federal government also employs a multi-rate income tax. Michigan's current flat rate for 2010 is 4.35 percent, and is scheduled to decline by 0.1 percentage point each year beginning on October 1, 2011, and until October 1, 2015, when it will be 3.9 percent.

If Michigan were to substitute a graduated income tax for its current flat rate tax, considerable additional growth in revenues (School Aid Fund and General Fund) could be realized. A restructuring of this nature could be fashioned to provide a net tax increase or decrease upon implementation, or it could be designed to be revenue-neutral initially.

The concept of graduating the income tax rate is relatively straightforward – as taxable income rises, the tax rate applied to successively higher increments of income also rises. Generally speaking, income taxes that have various rates are considered "progressive", meaning that a person's tax liability, as a fraction of their income, rises with income. A progressive tax structure is contrasted with a "proportional" structure, where everyone pays the same percentage of income in tax, regardless of income. In a broad sense, one tax structure is deemed to be more progressive than another if the average tax rate (tax liability as percentage of income) increases faster with increased income.

Looking at states that use a progressive income tax, the number of brackets employed and the rates charged vary considerably and therefore it can be concluded that there is no "typical" tax structure nationally. According to the Federation of Tax Administrators, two states have ten or more brackets (Hawaii and Missouri), but most states have three to six brackets.[41] In the Great Lakes region, Illinois and Indiana use a flat rate structure, and Minnesota, Ohio, and Wisconsin have progressive tax structures.

Income growth over much of the last half-century, nationally and in Michigan, has been concentrated in high income earners. Generally, income tax receipts under a graduated rate structure, assuming the same level of income growth, grow at a faster rate in a progressive rate structure than under a flat rate structure. If Michigan were to substitute a graduated income tax for its current flat rate tax, considerable additional growth in revenues (School Aid Fund and General Fund) could be realized. A restructuring of this nature, while it would require a change in the Michigan Constitution, could be fashioned to provide a net tax increase or decrease upon implementation, or it could be designed to be revenue-neutral initially.

Another method to achieve greater growth potential would involve expanding the base to include income that is currently untaxed. The pensions of former public employees are entirely exempt and pensions of former private sector employees are mostly exempt from Michigan's individual income tax. The value of these pensions, although not reflected in personal income statistics, is expected to grow at rates at least one and one-half times as fast as other sources of taxable income due in large measure to the state's aging population. The addition of this growing base would increase the growth potential of the income tax as a source of financing for K-12 schools and the General Fund. Folding private pension income into the income tax base could be accomplished statutorily; however, public pensions currently enjoy constitutional protection against taxation. Equity concerns would suggest that private and public pension income be treated equally from a tax policy perspective.

Currently-programmed income tax rate reductions will affect General Fund revenue stability, beginning

in FY2012. While education finances are isolated from the direct effects of the five-year, phased-in 0.45 percentage point rate cut, the fiscal impact to the General Fund will result in fewer discretionary dollars being available to supplement education services each year. A pause or elimination of the income tax rate reduction will enhance the stability of state revenues in the future.

State Education Tax

Revenues from the 6-mill State Education Tax (SET) did not perform as poorly as other major and minor state revenues when compared to economic measures from FY2001 to FY2008. This is not surprising given the fact that property taxes are less dependent on changes in broad measures of income to determine tax receipts. Property values exhibited strong growth throughout much of the seven-year period, which in turn produced similar annual levy increases for the SET. This is not expected to continue in the near-term due to a host of factors related to the bursting of the housing market "bubble", mortgage defaults, tax foreclosures, out-migration of Michigan residents, over-supply of residential property, and adjustments to commercial and industrial property values. As a result, levies from the SET and all other property taxes in Michigan are expected to decline in the coming years. [Note: CRC's May 2008 long-term assumptions regarding SET revenue performance over the 2007 to 2017 period (average annual growth rate of 4.25 percent) were clearly too optimistic given the myriad factors affecting property values in the intervening years.]

In the current and near-term environment, property assessments will continue to fall and drive down taxable values throughout the state. Although some areas of the state are harder hit than others, it is important to remember that the SET is a state-level tax and the effective base is all property in Michigan. The decline in this "statewide" tax base is expected to last three to five years; however, this short-term erosion of the tax base has long-term fiscal consequences because of the tax limitations contained in Proposal's A constitutional provisions. Proposal A's taxable value cap will dampen the recovery in the tax base and prolong the amount of time before previous tax levies are seen again. Proposal A restricts the growth on individual parcels to the lesser of inflation or five percent. All else being equal, this cap will limit the growth in the SET tax base from existing property to the rate of inflation, regardless of the strength of the recovery in the real estate market and resultant increase in property values statewide.

To modify the projected growth path of SET receipts coming out of the period of declining property assessments would require a statutory change in the tax rate or changes to the Michigan Constitution, to alter the modified acquisition value system of property valuation, which controls the growth of the base.

To modify the projected growth path of SET receipts coming out of the period of declining property assessments would require a statutory change in the tax rate or changes to the Michigan Constitution, to alter the modified acquisition value system of property valuation, which controls the growth of the base. Changing the assessment cap may be viewed as unpalatable given the fact that it was a major tenet of Proposal A's property tax relief provisions. Further, the assessment cap applies to all local property and a SET-only solution would be highly problematic. Each mill of the SET could be expected to yield roughly $300 million in the current year. Unless future rate increases were calibrated to account for the projected declines in the tax base in the coming years, the yield will fall in each year that the tax base declines. Thus, increasing the rate would provide temporary stability to the state revenue stream, but does very little to change the long-term growth potential of the SET.

Local Operating Property Taxes

In the post-Proposal A period, local property taxes continue to play a key role in financing school operations, both for local and intermediate school districts. Intermediate school districts rely heavily on property taxes to support operations; structural challenges facing this revenue source in the near- and long-term take on greater importance for these entities compared to local districts. All local operating taxes are subject to Proposal A's assessment cap, which will constrain tax revenue growth coming out of the period of declining assessments. Assuming everything else being equal, the cap on assessments holds the growth in tax base for most schools to the lesser of the rate of inflation or five percent, in exactly the same way that the base of the SET is affected by the per-parcel cap.

In addition to the per-parcel growth cap, local operating taxes are also subject to tax limitations that predate Proposal A. The 1978 Headlee amendment to the Michigan Constitution requires that, if the existing property tax base of a local government (e.g., school district) increases faster than the rate of inflation, the maximum authorized tax rate must be reduced or "rolled back" by a commensurate amount so as to produce the same property tax levy as would have been obtained from the old base. In a period of declining bases of local operating taxes (18-mill non-homestead tax or any other local operating tax), this tax limitation is moot. However, coming out of the period of declining assessments and taxable values, this limitation, in combination with Proposal A's per-parcel cap, will inhibit future revenue growth.

The rollback provision of the Headlee amendment can be triggered by the transfer of certain properties. A recovery in real estate markets is likely to be reflected in an increased number of properties being transferred. When ownership of enough properties, or of a few high-priced properties, is transferred, taxable values for those individual properties "pop up" to 50 percent of the true cash value. When these "pop ups" are added to the tax rolls, the tax base of some school districts will grow at rates faster than inflation. In such a case, a rate rollback is initiated and reduced rates applied to all properties. The net result will be that growth in the property tax levy is held below the growth in inflation.

Coming out of the current period of declining property values, the interaction of the Headlee amendment and Proposal A's assessment cap will forestall recovery in the tax bases of school districts, effectively prolonging the effect of the current housing market downturn. A statutory response is available, despite the fact that both tax limitations are contained in the Michigan Constitution. The interaction of the cap on assessments and the Headlee rate rollback is determined in the statutory definition of property tax base "growth", which includes both the per-parcel inflationary factor as well as the "pop up" effect. Redefining tax base "growth" to exclude "pop ups" would allow the tax base of existing property to grow at a rate that approximates, or slightly exceeds, inflation. This would add stability to future local property tax revenues.

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Another avenue to address future growth in local operating taxes for local districts would involve further centralization of the finance system by shifting property taxes currently levied at the local level to the state level. The 18-mill local operating tax is effectively a state-level tax given the statutory limits placed on the maximum rate allowed (e.g., lesser of 18 mills or 1993 tax rate) and the tight limitations on tax base growth (Headlee and Proposal A provisions discussed earlier). Making the 18-mill tax a state-levied tax, similar to the SET, would exclude the tax from Headlee rollback provisions because state taxes are not subject to automatic rate reductions triggered by base adjustments. Such a shift toward greater centralization would eliminate some election costs at the local level associated with both "Headlee override" votes as well as constitutionally-required millage "renewal" votes. Override votes can occur more frequently than renewal requests. These votes occur at the request of the local school

district in order to restore all, or a portion, of the previous millage rate reduction.

Consideration might also be given to the possibility of exempting local and intermediate school district property taxes from the Headlee rollback provisions. This would require constitutional changes; however, it would comport with some peoples' general understanding of how the 18-mill foundation allowance property tax was intended to work.

Revenue generated from the 18-mill non-homestead property tax (or whatever the level was for those districts levying less than 18 mills in 1993) is collected and retained locally and is dedicated to the foundation allowance within each district. For purposes of calculating the state portion of a district's foundation allowance payment each year, state law requires that this payment be based on the assumption that a millage rate reduction has not occurred. In other words, the state assumes that the full 18 mills (or 1993 rate, whichever is less) is being levied locally when it determines its share of a district's foundation allowance payment each year, regardless of the actual rate levied.[42] Given the workings of the foundation allowance program (i.e., local dollars first), the practical effect of this provision is that a district that does not have authorization to levy the full 18-mill tax will not receive the full amount of local revenue to support its per-pupil foundation allowance and therefore does not receive the full amount of its per-pupil foundation to support operations. For districts affected by the rollback provisions of Article IX, Section 31 of the Constitution, this shortfall in the local revenue component of the foundation allowance is not offset by higher state aid payments. These "lost" dollars cannot be recaptured in future years and can accumulate to amount to significant funds for schools.

Under a tax restructuring scenario, each local district could be guaranteed the tax levy at the full 18-mill rate (or corresponding 1993 level if less) each year, which in turn would add some degree of revenue stability to the system. Some argue this was the intent of Proposal A and such a shift would honor the integrity of the original foundation allowance concept. The base of this tax would remain the same and receipts would continue to be directed to the local foundation allowance. For intermediate school districts, the full amount of previously-authorized millage rates would be guaranteed.

Another option, short of full exemption from the Headlee rollback provisions, involves the restoration of the Headlee tax rate "rollup" provision. This would not require a constitutional change, but would necessitate a statutory modification. Prior to Proposal A, the General Property Tax Act (Public Act 206 of 1893) allowed tax rates (for all units of government) to rollup to previously-authorized, voter-approved maximum levels in years in which property assessment growth lagged the inflation rate. Basically, if previous years' Headlee rollbacks had reduced tax rates below the originally-authorized maximum level, a formula in state law permitted tax rates to automatically increase without a vote of the local electorate, up to the maximum level. The tax rate increases in such cases were not allowed to result in tax yields that exceeded inflation.

Another option, short of full exemption from the Headlee rollback provisions, involves the restoration of the Headlee tax rate "rollup" provision.

State law changes that accompanied Proposal A (Public Act 145 of 1993) effectively eliminated the option of Headlee rollups during the current period of declining property values and tax bases. Under current state law, local and intermediate school districts must obtain voter approval to return operating tax rates to the levels previously authorized if tax rate rollbacks had occured. While some districts are at the statutory maximum for the various operating property taxes (e.g., 18-mill foundation, ISD general operations, ISD special education, and ISD vocational education), a great many are currently levying rates well below the maximum allowed. These districts will have to obtain voter approval to raise tax rates in response to declining tax bases in the coming years. Revenue stability, during times of falling property values, would be enhanced if state law provided for the automatic rate increases, not to exceed previously-approved maximum rates, and capped by the constitutional inflationary limit on the tax yield.

Tobacco Taxes

The overall growth, and therefore stability, of education revenues also is affected by the structure of minor taxes dedicated to financing schools. The performance of these taxes, as previously noted, is contingent on factors largely independent from economic activity in the state. The performance of these taxes, if stagnant or negative, will constrain the positive growth of other major taxes. These minor tax sources constitute a small portion of the overall funding going to schools therefore their potential to affect the overall growth rate is somewhat limited. However, despite their limited role, a case can be made for structural changes to select minor tax sources.

To modify the growth rate of cigarette taxes as a future revenue source for schools will require a transition from a *unit* or *excise* tax to an *ad valorem* tax or one based on the value (price) of the product sold.

In Michigan, nearly $1 billion in tobacco tax receipts (cigarette and other tobacco products such as cigars, loose tobacco, and smokeless tobacco) were received in FY2009. Schools, through the School Aid Fund earmark, receive 42 percent each year of the cigarette tax proceeds ($410 million in FY2009). These funds account for four percent of total taxes going to the School Aid Fund in FY2009; however, tax receipts declined 16 percent since FY2003 (when they represented five percent of total) in response to declines in tobacco use and consumption. This trend is expected to continue into the future. Because of the current structure of cigarette taxation and without tax rate increases, continued consumption declines will limit tax yields and hamper the overall stability of education funding, as this source of funding declines. While rate increases can generate additional resources in the short term, consumption patterns will determine the long term growth rate of this revenue source.

To modify the growth rate of cigarette taxes as a future revenue source for schools will require a transition from a *unit* or *excise* tax to an *ad valorem* tax or one based on the value (price) of the product sold. [Note: Non-cigarette tobacco taxes are ad valorem in nature. Currently, the tax on other tobacco products is levied at 32 percent of the wholesale price and the proceeds dedicated to the General Fund and the Medicaid Benefits Trust Fund.] Initially, the ad valorem rate could be set to provide the same revenue that the current unit tax raises. Alternatively, the rate might be structured to generate additional resources initially to make up for the erosion in the tax base that that has occurred in recent years with consumption declines. Any policy discussion about transitioning to an ad valorem tax would likely consider the public health, tax regressivity, and tax evasion issues that accompany tobacco taxation in general.

Another option to enhance overall revenue stability that involves the current cigarette tax would be to eliminate this source from the School Aid Fund and redirect the proceeds to another state fund. The revenues could be replaced, dollar-for-dollar, with the proceeds from another tax source that responds to economic growth (i.e., portion of sales or income taxes). Eliminating this negative growth tax source from school funding, while at the same time replacing the revenues with a positive growth source, would better align overall revenue growth with the economy.

Local Revenue Supplementation

In general, local governments in Michigan (general- and special-purpose) are constrained both in the *types* of taxes that they can use and in the tax *rates* that they are permitted to levy to finance public services. Furthermore, as previously noted, state constitutional and statutory provisions control the upper bound of annual growth in property tax bases, both at the individual and unit-wide level. The property tax is the most important revenue source available to local governments and it is constrained by both rate and base limitations contained in state law. The current system of strict state fiscal regulation of local government finances limits taxation options available to all types of local governments, including local and intermediate school districts. Although unique in a number of respects from other types of local government, public education finances have to be understood in the broader context of Michigan state-local government fiscal relationships.

Michigan's current education finance system considerably restricts the ability of local and intermediate school districts to pursue additional, locally-generated operating revenues. In a period of rising state funding and rising property values, which was the case following Proposal A's adoption, such restrictions could be merited given concerns that such local authority, if acted upon, might result in inter-district per-pupil revenue disparities and counteract the state policy objective to curtail such inequities. In the current and near-term environment, annual state revenues have been falling and revenue growth going forward is likely to be minimal. At the same time, local operating property tax revenue growth is slowing in nearly all communities across the state and declining in many. Providing authority for local and intermediate school districts to address the current revenue declines by supplementing current revenues, if districts so choose, might provide a mechanism to manage through the current period and provide future stability. While there are numerous ways to authorize greater options for local revenue supplementation, the most likely option to pursue involves the current "enhancement" property tax.

Modifying or eliminating the current ISD-wide enhancement millage to provide additional flexibility for districts are options that could be pursued. First, replacing the regional tax with a district-specific enhancement option (up to 2 or 3 mills), similar to that available immediately following Proposal A's adoption, would provide a mechanism to deal with falling state and local resources. Concerns over widening the "equity gap" among districts could be addressed if the local millage yield is based on the average regional or statewide property value. The current ISD-wide millage results in tax base sharing to equalize revenues at the per-pupil level. A similar level of equalization could occur if the additional dollars generated by districts with above-average property values were directed to a regional- or state-level pot to be used to supplement millages levied by districts with below-average property values.

A second option might involve the retention of the current ISD-wide millage concept, but with modification to eliminate the current approval threshold. Currently, state law requires that the question be placed on the ballot only if one or more constituent districts, representing a majority of students of the ISD, request it. Millage passage requires approval from a majority of the electors in the ISD, including electors in districts that did not request the millage originally.

An alternative approach might retain the provision regarding the necessary steps to gain access to the ballot (i.e., request by district(s) representing majority of students in ISD); however, what would change is that approval to levy the millage would be granted only to those constituent districts that passed the millage. The potential concern is that this could reverse some of the equity gains if only the high-revenue districts are successful in securing additional local revenues; however, it will promote further per-pupil equity if the low-spending districts avail themselves of the option. Caution would also have to be paid to the level and duration of such millages to guard against a long-term, sustained erosion of Proposal A's per-pupil funding equity gains.

The proceeds of new, local operating revenues might be earmarked for certain services. Consideration might be given to options that provide local and intermediate school districts with limited authority to seek millages for "optional" programs, such as transportation and athletics. While outside of the classroom, these services play an important role in the overall education and development of Michigan school children.

Current state law establishes the maximum tax rates that ISDs can levy for general operations, special education and vocational education. These limits were established in a different environment, and most likely, based on assumptions that have recently proven to be false (i.e., sustained and consistent property value escalation). Although the caps on these rates did allow rate increases over time, the question arises whether these caps should be reviewed periodically, especially in light of the fact that the financing system is nearing 20-years-old. A number of districts have managed to secure voter approval to increase rates and many more are expected to do so in the coming years in response to falling property values. A review and potential adjustment to the maximum ISD tax rates might provide future stability to district funding levels, especially for those that have exhausted their ability to raise rates

Appendix A

School Operating Property Taxes: Brief Overview

From an operating revenue perspective, traditional local school districts (excluding intermediate school districts and public school academies) have available to them local property tax revenue from three primary sources. Intermediate school districts have access to three separate local millages to support their operations, but public school academies can not, by law, levy property taxes. Of the three sources available to traditional K-12 districts, two are available to all districts and one tax is available only to a small subset of districts with traditionally higher per-pupil spending. Voter authorization is required to levy any of the three taxes. The first source is the 18-mill property tax or what most people refer to as the basic operating tax. The second operating property tax is available only to 51 districts that had per-pupil revenue in excess of $6,500 in FY1994, commonly called a "hold harmless" millage. Both the "hold harmless" and 18-mill property taxes must be dedicated to the foundation allowance program. Finally, all districts are eligible to share equally in the revenue from a three-mill enhancement millage, assuming voters approve such a regional tax. These very rare taxes (only three districts currently levy) must be levied across an entire intermediate school district and the resultant proceeds shared on a per-pupil basis, regardless of the origins of the tax revenues. These three sources represent the entire universe of local operating property taxes under the current school finance system.

Foundation Allowance 18-Mill Tax

A major change accompanying the school finance reforms of the mid-1990s was the adoption of a foundation allowance program as the primary mechanism for distributing general assistance to local school districts. This system replaced the previous power equalization method of determining state aid allocations. Under the foundation program, effective for the first time in FY1995, the state guarantees each district a basic level of per-pupil funding. As is the case with foundation grant programs in other states, the Michigan model requires a certain degree of local tax effort. In Michigan's case, state law sets the maximum tax rate and the tax base for this local property tax, leaving little room for local taxing discretion.

Some have maintained that although technically a local property tax, this tax more accurately resembles a state property tax similar in many respects to the State Education Tax (SET). The argument supporting this position is based on the fact that both the base and rate of the tax are set in state law and the only "local" aspect of the tax relates to the fact that the proceeds are retained locally for the per-pupil foundation allowance program. Recall, under Michigan's previous school finance system, school operating tax rates were determined at the local school district level through elections, subject only to state tax rate limitations. While the two taxes do share some similarities, enactment of the SET did not require voter approval and it is not subject to tax rate rollbacks pursuant to 1963 Michigan Constitution.

The Revised School Code allows each local school district to levy an operating tax at the rate of 18 mills or the number of mills levied in 1993, whichever is less. The proceeds are strictly dedicated to support a district's per-pupil foundation allowance. The Code further provides an exemption from this tax for certain property, generally referred to as the homestead exemption.[43] Initially, the original 18-mill exemption applied to certain residential and agricultural property, but over time this exemption was extended to other types of property.[44] The remaining property subject to the tax is generically referred to as non-homestead property. Generally, this is property that is classified as business (commercial, industrial, and utility) and residential property that is not owner-occupied (i.e., second residences, rentals).[45]

The 18-mill non-homestead property tax is subject to the millage rate reduction provisions of Article IX, Section 31 of the Michigan Constitution. Section 31 requires a reduction in the maximum authorized rate of a tax (including school operating) if the base of the tax is broadened by redefinition or if the assessed valuation of property as finally

equalized increases by more than the rate of inflation. In essence, this tax limitation requires property tax rate reductions to counteract the growth in the property tax base, excluding new construction, that exceeds the growth in inflation. The effect of the limitation is to hold the growth in the property tax revenue yield on existing property equal to the growth in inflation.

Following enactment of the school finance reforms and the establishment of 18-mill tax, 536 of the 556 school districts levied the full 18-mill tax. Of the 20 districts levying less than 18 mills in 1994, 13 did so because their 1993 school operating millage rate was less than the mandated 18-mill level. The remaining seven districts levied fewer mills either because they chose to or as a result of an automatic rate reduction.

"Hold Harmless" Tax

The Michigan school finance reforms of the 1990s were designed, in part, to address the per-pupil revenue inequities across districts. One explicit policy approach to address these disparities was to provide larger increases to districts with lower per-pupil revenues compared to the increases provided to higher-revenue districts. Also, it was decided that equity would not be achieved by reducing the amounts received by higher revenue districts. A corollary to the "raising the bottom" approach adopted in the reforms involved allowing certain districts to raise additional revenue through a local property tax to support higher revenue. For those eligible districts, this "hold harmless" tax is in addition to the 18-mill non-homestead local school operating property tax.

The per-pupil revenue threshold to qualify as a "hold harmless" district in FY1995 was $6,500. Districts with combined state and local revenue above this amount were eligible to levy, with voter approval, an additional property tax sufficient to ensure that the higher per-pupil revenue amount was achieved. State law requires that the "hold harmless" tax first be applied to the homestead property tax roll, up to a total of 18 mills. If the revenue yield from such a levy is insufficient for meeting a district's per-pupil revenue level, then the tax must be levied equally on both homestead and non-homestead property.

In much the same way that the 18-mill operating tax is strictly controlled by state law, the Revised School Code contains three limitations on the rate of "hold harmless" tax or its yield. Specifically, qualifying districts are able to levy the tax at a rate sufficient to produce a total state and local revenue figure equal to the amount available to the district in FY1995. This provision ensures that a "hold harmless" district receives at least as much in total resources under the new financing system as it did before Proposal A. Second, the rate must be reduced in any year if the per-pupil revenue yield from the tax exceeds the lesser of the dollar increase in the basic foundation allowance or the increase in inflation, which might occur in an environment of rapidly rising tax bases. This provision prevents the growth in the tax from exceeding the growth in inflation in order to avoid further widening the per-pupil funding gap between "hold harmless" districts and those receiving the basic level of per-pupil funding. Finally, a hard cap was instituted that prevents the tax rate from exceeding the level determined by the state for 1994, the first year of the tax.

Upon enactment of the school finance reforms in 1994, 51 districts had per-pupil revenue levels above the $6,500 level in FY1995 and were authorized to levy the "hold harmless" local property tax. However, before the tax was levied in 1994 for the FY1995 budget, the State School Aid Act was amended to effectively reduce the number of districts that would be required to levy this tax in order to maintain their higher revenue level. The amendments provided state supplemental payments in lieu of and equal to the local property revenue that would have been received from the "hold harmless" millage for two groups of high-revenue districts: 1) districts that would have to levy less than one-half of one mill (0.5 mills), and 2) low-population districts (defined as those with 350 or fewer students). For these eligible districts, the state provides a supplemental payment from the School Aid Fund equal to the amount that each district would have received from the "hold harmless" levy at the local level. As a result of the changes to the state law enacted sub-

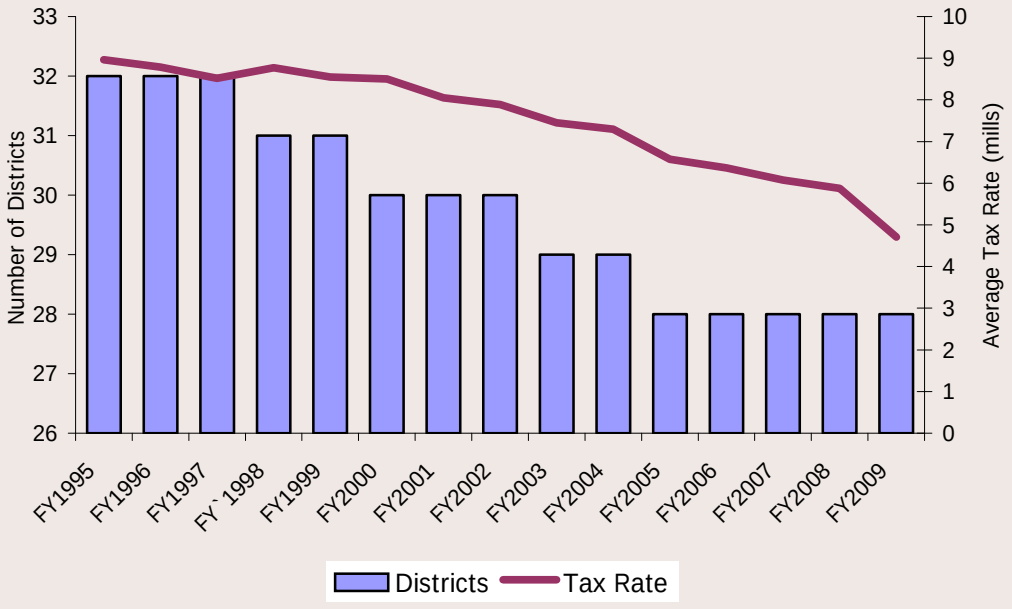
sequent to original Proposal A reforms, only 32 districts collected the tax in the first year (1994) of its existence (See **Chart 26**). In 1994, the rates levied ranged from 21.88 mills in Southfield (Oakland County) to 0.7 mills in East Lansing (Ingham County), with an average figure of 8.97 mills among all eligible districts.

The number of districts levying the tax has declined from a total of 32 in FY1995 to 28 in FY2009.[46] Over the same period, the average rate among these districts has decreased to 4.71 mills, from 8.97 mills originally, as a result of growth in the property tax base upon which the tax is applied and a recent tax policy change. The average rate dropped from 5.88 mills to 4.71 mills in FY2009 (20 percent) as a result of a law change that effectively moved commercial and industrial personal property into the homestead category of property for purposes of school operating taxes.[47] This shift provided property tax relief from the 18-mill non-homestead school operating tax, but simultaneously subjected the property to the "hold harmless" tax, which is levied on homestead property first. The shift only affected property in school districts levying the "hold harmless" tax.

Enhancement Millage

The third type of school operating property tax available to K-12 districts is commonly referred to as an enhancement millage. The state authorization for this tax levy changed soon after the passage of the school finance reforms. Initially, the tax was a district-wide levy, which allowed individual districts to seek a maximum rate of three mills for a maximum of three years. As with the 18-mill and "hold harmless" operating property taxes, this tax is subject to voter approval. Authorization to levy a district-wide enhancement millage existed for a transitional period only, FY1995 through FY1997 (tax years 1994 through 1996). Beginning in FY1998, the tax had to be levied on a regional basis.

Chart 26
Districts with Hold Harmless Millages and Average Tax Rate: FY1995 through FY2009



Source: Michigan Department of Education

Current state law requires local-option enhancement millages to be levied at the intermediate school district level. The maximum rate is three mills for up to a period of 20 years. The tax is assessed against all property within the district. Before asking local voters within the intermediate district to approve such a tax increase, a resolution requesting the tax must be approved by constituent districts accounting for a majority of the students within the intermediate district (excluding public school academies).

The proceeds from an enhancement millage must be distributed to the constituent districts within the intermediate district on a per-pupil basis and may be used for local school operations. Public school academies are not eligible to receive the proceeds from the tax. Three districts currently levy such a tax: Kalamazoo Regional Educational Services Agency (1.5 mills first authorized in 2005), Monroe Intermediate School District (0.9866 mills first authorized in 1997), and Midland County Educational Service Agency.

Intermediate School District Millages

The centralization of school finances at the state government level did not affect intermediate school districts (ISDs) as severely as it did local school districts. Although amounts vary across districts, as a group ISDs continue to receive the majority of their funding from local sources, in much the same way as they did before Proposal A.[48] Considerable variation in service provision (both type and extent) exists among ISDs, which explains some of the funding discrepancies between entities. The variation in ISD services is fully explained in a separate chapter on the subject in the first report in this series, *Public Education Governance in Michigan*.[49] As an example of the still-prominent role played by the local resources, in FY2008, these comprised 60 percent of all ISD funding statewide, followed by 18 percent from state sources, and 22 percent from federal sources. Federal sources constitute a larger share of overall ISD finances compared to local districts because of the leading role ISDs play in the provision of special education services. Again, considerable variation exists among ISDs as to the component shares of each district's total budget. As is the case with local districts, the major own-source revenue available to ISDs is the property tax. Because of the majority role played by local resources at the ISD level, the property tax remains the primary funding source for district operations, unlike local K-12 districts.

ISDs have authority to levy property taxes for: 1) general operations, 2) special education operations, and 3) vocational education operations. General operating property taxes continued after adoption of Proposal A of 1994 subject to the processes in place for tax allocation boards (in 13 counties) and for separate tax limitations (in 70 counties). Authorization to levy dedicated taxes for special education or for vocational education, and as part of the school finance reform for increased general operating millages, requires voter approval. The maximum rate for each purpose is capped and all ISD tax rates are subject to Headlee tax rate rollback provisions of the Michigan Constitution.

Sinking Funds

The Revised School Code authorizes local school districts, with voter approval, to levy up to five mills for up to 20 years to create a "sinking fund". Public school academies are prohibited from levying a sinking fund millage. Despite some popular misunderstandings to the contrary, sinking funds are not available to be used for operating purposes. Thus, sinking fund tax levies cannot be considered operating taxes in the context of Michigan education finances.

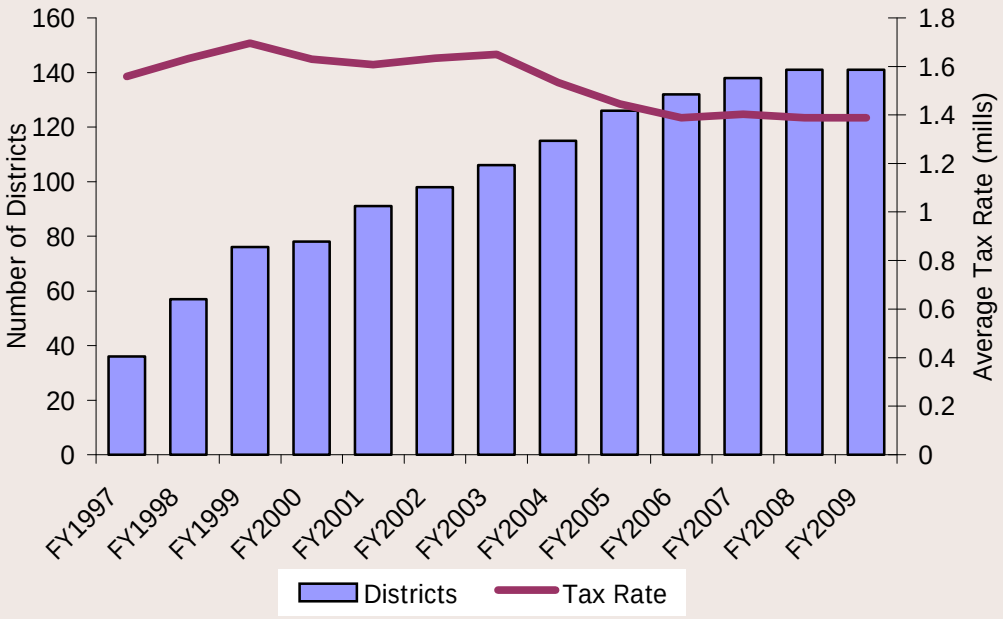
State law narrowly defines the allowable uses of the proceeds from sinking fund levies. The Revised School Code limits the use of sinking funds to the "purchase of real estate for sites for, and the construction or repair of, school buildings." Generally, sinking funds are considered a method of financing capital improvements without having to issue long-term debt, which is the traditional mechanism for funding such projects. However, some projects that may be financed through the issuance of debt may not be financed through the use of sinking fund proceeds.[i] The authorization provided to local districts to levy a sinking fund millage pre-dates the Proposal A reforms of the mid 1990s.

The use of sinking funds among districts has increased since the adoption of school finance reforms in the mid-1990s. A single definitive reason for this observed growth is not clear; however, it is likely that school districts use this method as a cost-conscious alternative to traditional debt issuance to finance capital expenditures. It is also likely that the reduction in school operating property taxes that accompanied Proposal A provided communities with room under constitutional tax limits (e.g., 50 mills) to levy sinking fund millages, among other uses.

The number of districts statewide levying sinking fund millages grew steadily from FY1997 (36 districts) to FY2007 (138 districts), before reaching a plateau and remaining constant in recent years (See **Chart 27**). In

[1] The Michigan Department of Treasury maintains a listing of eligible projects that may be financed with the proceeds from sinking fund millages. A couple notable omissions from the listing include technology equipment and software, although wiring and installation are permissible uses of sinking fund dollars, and transportation services (e.g., bus equipment purchases). Local school districts with sinking fund millages are required under The Revised School Code to have an independent audit conducted each year to ensure that fund proceeds are used according to state law.

Chart 27
Districts with Sinking Fund Millages and Average Tax Rate: FY1997 through FY2009fr



Source: Michigan Department of Education

FY2009, 141 districts (out of the 551 districts with taxing authority) levied a sinking fund millage. The average millage rate among these districts was 1.39 mills, down from the average figure in FY1997 (1.56 mills) (See **Chart 26**). The range of millage rates in FY2009 varied from the statutory-maximum five mills (Inkster) to a low of 0.24 mills (Suttons Bay).

In FY2010, according to data reported by the Michigan Department of Treasury, a total of $124.7 million was raised for sinking funds statewide.[ii] This represents more than double the amount that was raised from sinking fund millages in FY2002 ($56.8 million).[iii] This growth is a product of the number of districts levying a tax and the increase in the tax base of these districts over time.

[ii] Michigan Department of Treasury, analysis of sinking fund millages and tax bases for FY2010, unpublished date provided by Howard Heideman, Office of Revenue and Tax Analysis, February 2010. This represents revenue received by school districts and does not include tax revenue "captured" by tax increment finance districts and renaissance zones.

[iii] Michigan School Business Officials (MSBO) study conducted by Robert Kleine, 2002. Accessed on MSBO website February 2010.

Districts that levy a sinking fund millage appear to use this mechanism of capital financing as a partial alternative to bonded debt. Districts with sinking fund levies have an average of 3.17 mills for debt retirement, compared to 4.46 mills for all other districts. The combined average sinking fund and debt retirement millage in districts using sinking funds is just slightly higher (4.56 mills) than in districts that do not have a sinking fund millage (4.46 mills). Further evidence that sinking funds may be used in lieu of traditional debt-financing is seen in the number of districts that do not levy any debt retirement millage. In FY2010, 24 of the 142 districts with sinking fund millages do not levy debt millage, or about 17 percent of the districts in this grouping. For those districts not using sinking funds in FY2010 (410 districts), 12.4 percent (51 districts) do not levy debt millage.

A sinking fund millage can be a cost-effective method to finance capital improvements because it does not entail the costs associated with bonded debt (e.g., interest expense, debt issuance costs, etc.). As opposed to using debt-financing to pay for a capital improvement, sinking funds provide districts with a "pay-as-you-go" alternative. Although sinking funds provide flexibility with respect to capital projects, they cannot be used to support on-going operational costs such as routine maintenance.

Endnotes

[1] The State of Michigan's fiscal year runs from October 1 to September 30 of the following year. Many units of local government in the state, including local and intermediate school districts, have fiscal years that begin on July 1 and run through June 30 of the next year.

[2] Senate Fiscal Agency, *State Revenue Limit (Article IX, Section 26)*, www.senate.michigan.gov/sfa/Revenue/StateRevenueLimit.PDF

[3] Additionally, Proposal A made changes to two other sections of the Michigan Constitution, unrelated to school finance reform. First, the ballot proposal amended Article IX, Section 5, to require that utility property be taxed at a rate equal to the statewide average rate of other "commercial, industrial, and utility" or business property. Previously, this property was taxed at the statewide average rate instead of the actual rate or the jurisdiction in which the property is located. Second, Proposal A provided a new earmark (6 percent) of tobacco product taxes to health care improvements (Article IX, Section 9).

[4] Data include all public K-12 education services, including those provided by K-12 school districts (traditional public and public school academies) and intermediate school districts. Data obtained through the National Public Education Financial Survey is collected by the Michigan Department of Education and reported to the National Center for Educational Statistics (NCES).

[5] The Kalkaska School District closed 10 weeks early in the early spring of 1993 after voters rejected three separate attempts to raise additional school operating funds to help fund a reported $1.5 million deficit for that school year.

[6] The Headlee Amendment refers to a multi-part amendment to the 1963 Constitution, which added Sections 25 to 34 to Article IX. "Headlee" refers to the primary proponent of the amendment, Richard Headlee. The rate rollback provision (Section 31) requires that when the growth in assessed value of property jurisdiction-wide, excluding new construction and improvements, exceeds the growth in inflation then the millage rate must be "rolled back" so that the growth in tax receipts does not exceed changes in the inflation rate.

[7] Citizens Research Council of Michigan, *Proposal A: Questions Regarding School Property Taxes*, Council Comments 1028, June 1994.

[8] This report relies on the National Public Education Financial Survey data, to show operating revenues for K-12 and intermediate school districts. This is the only known source that provides operating revenues broken down by source.

[9] Throughout this paper, annual rates of growth are used to describe the performance of revenue, income, wages, prices, and other variables between two points in time. When the terms "annual growth rate", "annualized rate", and others are employed in the text of the paper, the mathematical computation behind these terms is the compound annual growth rate (CAGR). This metric is different than the arithmetic mean, which simply takes the average of annual rates observed over a period of time.

[10] Originally, the 6-mill State Education Tax was collected about equally on the summer and winter tax bills by local governments responsible for collecting the tax on behalf of the State of Michigan. State law changes were enacted in response to weak SAF revenue growth during FY2002 that changed the collection date for this tax. The changes advanced the collection of the tax entirely to the summer tax bill (July) begging in 2002, effectively pulling forward into FY2002 revenue that would have been received in FY2003. As part of the change, the state law reduced the tax for the July 2002 bill to 5 mills. Overall, the change resulted in a one-time cash-infusion for the SAF of $475 million.

[11] Senate Fiscal Agency, *Doesn't the State Lottery Fund the Schools?,* State Notes, December 2009.

[12] With respect to K-12 education-related costs that are the obligation of the General Fund in the FY10 budget, four items account for almost three-quarters of the total annual General Fund transfer ($30.2 million). The largest single item ($9.2 million) is provided per state law to reimburse the School Aid Fund for lost property tax revenue associated with the establishment of renaissance zones. The next largest item ($7.6 million) is intended for competitive school readiness programs. Finally, the General Fund supports a portion ($5.2 million) of the total costs of the operations of the Center for Educational Performance and Innovation and Michigan Virtual High School. Senate Fiscal Agency. *Summary of PA 121 of 2009 School Aid Budget for FY2010*. October 2009.

[13] The National Bureau of Economic Research, the most-cited organization for dating the business cycle, announced in November 2008 that the U.S. economy slipped into recession in December 2007. Although the NBER has not officially announced an end to the most recent recession, many economists believe that the recession ended sometime in the late summer of 2009.

[14] Estimates are based on the May 2009, Consensus Revenue Estimating Conference. Detailed data provided by the Michigan Department of Treasury.

[15] Article IX, Section 6 of the Michigan Constitution sets a maximum period of 20 years that electors can authorize ad valorem taxes on real and tangible personal property. Generally, local school districts authorize the 18-mill tax for periods much shorter than the constitutional maximum.

[16] Article IX, Section 25 of the Michigan Constitution requires voter approval to increase property tax rates above those specified in Constitution, including those affected by the rollback provisions of Section 31.

[17] Citizens Research Council of Michigan. *Public Education Governance in Michigan*. Report 359. January 2010.

[18] Ibid.

[19] Citizens Research Council of Michigan. *State Budget "Balance" for FY2007 Achieved with $1 Billion in Additional Non-Recurring Resources.* June 2007.

[20] Dye, Richard F. (2004). "State Revenue Cyclicality." *National Tax Journal,* vol. 57, no. 1.

[21] White, Fred C. (1983). "Trade-Off in Growth and Stability in State Taxes." *National Tax Journal,* vol. 36, no. 1.

[22] Sobel, Russell S., and Randall G. Holcombe (1996). "Measuring the Growth and Variability of Tax Bases Over the Business Cycle." *National Tax Journal,* vol. 49, no. 4.

[23] Senate Fiscal Agency, *Economic and Budget Stabilization Fund Transfers, Earnings and Fund Balance FY 1977-78 to FY2007-08*, March 2009.

[24] Michigan School Business Officials, *Fund Balance and Related Issues*, webpage document (www.msbo.org), March 2010.

[25] Michigan School Business Officials, Testimony of David Martell, Executive Director, Michigan House Education Committee re: HB 5963 (www.house.michigan.gov/SessionDocs/2009-2010/Testimony/Committee5-3-25-2010-4.pdf), March 18, 2010.

[26] Citizens Research Council of Michigan. *The State Fiscal Plan*. Council Comments No. 941. June 1983.

[27] House Fiscal Agency, *Review and Analysis of FY2010-11 Executive Recommendation*, March 2010.

[28] The trend toward adequacy litigation began with the 1989 landmark decision in *Rose v. Council for Better Education*, in which the Kentucky Supreme Court declared the state's entire school system unconstitutional and inadequate to fulfill the education "rights" of Kentucky schoolchildren.

[29] Michigan Department of Treasury, *Executive Budget Appendix on Tax Credits, Deductions, and Exemptions FY2010*, February 2010.

[30] Doug Drake. *A Review and Analysis of Michigan Tax Policies Impacting K-12 Finances.* Michigan Association of School Administrators, Michigan Association of School Boards, and Michigan Association of School Business Officials. June 2002.

[31] According to a 2007 survey of states conducted by the Federation of Tax Administrators, Michigan taxes very few services. Of the total 168 unique services identified in the survey, Michigan directly taxes 26 of total, or about 15 percent. The average number of services taxed by states as of July 1, 2007, was 56.

[32] "Nexus" is defined as a minimum physical presence in a state that would allow a business to be subject to a state's tax system and required to collect and remit taxes.

[33] Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division. *Michigan Sales and Use Taxes 2008.* December 2009.

[34] Citizens Research Council of Michigan, *Michigan's Fiscal Future*, Report 349, May 2008.

[35] Elizabeth McNichol, Center on Budget and Policy Priorities, *Revisiting State Tax Preferences for Seniors*, May 2006.

[36] Federation of Tax Administrators, *State Sales Tax Rates and Food & Drug Exemptions*, February 2010.

[37] Federation of Tax Administrators, *Survey of Services Taxation – Update*. July 2008.

[38] Donald Bruce, William F. Fox, and M.H. Tuttle, "Tax Base Elasticities: A Multi-State Analaysis of Long-Run and Short-Run Dynamics", *Southern Economic Journal,* October 2006.

[39] Citizens Research Council of Michigan, *Michigan's Fiscal Future*, Report 349, May 2008.

[40] Center on Budget and Policy Priorities, "Expanding Sales Taxation of Services: Options and Issues," July 2009.

[41] Federation of Tax Administrators, *State Individual Income Taxes*, February 2010.

[42] The State School Aid Act.

[43] As currently written, The Revised School Code exempts property classified as a "principal residence" from the tax. Historically, this exemption was considered the "homestead" exemption; however, its name was changed to "principal residence" to avoid confusion with a popular income tax credit called "homestead". The designation of "principal residence" applies only to the residential classification of real property and generally refers owner-occupied property.

[44] Initially, the 18-mill exemption applied to property that qualified as a "homestead" or "principal residence". Over time, the 18-mill tax exemption has been expanded, in total or in part, to include other types of property, including qualified agricultural property, qualified forest property, supportive housing property, commercial personal property, and industrial personal property.

[45] Changes to state law in 2007 generally intended to restructure the overall business tax climate in Michigan resulted in exemptions from 18-mill tax for industrial personal property (full exemption) and commercial personal property (exempt 12 mills).

[46] The following districts, which initially levied the tax in 1994, did not levy the tax in 2008: Covert, Jefferson, Melvindale, and Watersmeet Twp. These districts abandoned the tax at different times over the years.

[47] Public Act 37 of 2007 exempted industrial personal property from the full 18-mill non-homestead property tax and provided a partial exemption (up to 12 mills) to commercial personal property. Treating the property in this manner effectively subjected these property classifications to the "hold harmless" millages in those districts eligible to levy such a tax, which is levied first on homestead property.

[48] Citizens Research Council of Michigan. *Public Education Governance in Michigan*. Report 359. January 2010.

[49] Ibid.