STATE BUDGET NOTES

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Using State Shared Revenues to Incentivize Local Government Behavior

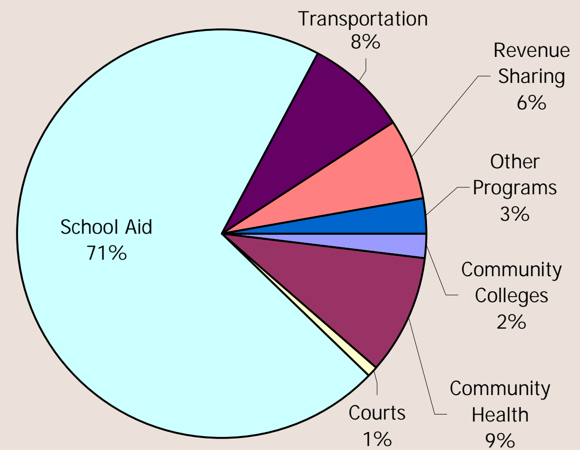
Governor Snyder's first state budget (FY2012) is significant for a number of reasons: the breadth of appropriation reductions enacted to address a projected $1.5 billion General Fund deficit, the effects of the business/individual income tax reform package (a net tax cut) on the amount of state resources available, and the interchangeable use of the School Aid Fund and General Fund to finance education appropriations. Also notable is a not-so-subtle shift in how the state shares its financial resources with sub-state entities – K-12 school districts and general purpose local governments. The main thrust of the shift requires these entities to engage in certain behaviors as a condition of receiving state funding, as opposed to the state's previous practice of providing state collected resources without "strings" attached. The FY2012 state budget established the foundations for this policy shift and the FY2013 budget expands the practice to other entities.

Background

The State of Michigan shares state-generated resources with local units of government – cities, villages, townships, counties, community colleges, and school districts – using a variety of methods. State revenue distribution payments are financed as a share of a specific state tax or from a state fund which receives revenue from a variety of taxes. Some state revenue distribution programs are spelled out in the 1963 Michigan Constitution, while others are contained in statutory provisions, some of which are subject to annual appropriation decisions.

State revenue distributed to local governments is a significant share of the overall state budget: it represents nearly three-fifths (almost $15 billion) of all state spending from state resources in FY2012. **Chart 1** summarizes the major categories of state payments to local units in the current year. The school finance reforms of the mid 1990s replaced local property taxes with state distributions and as a result, K-12 state aid comprises nearly three-fourths of total state distributions today. Unrestricted general revenue sharing to cities, villages, townships, and counties (statutory and constitutional payments), once the second largest portion, has declined to the fourth largest component (6 percent of the total) because of reduced state sales tax collections over the Great Recession and the sizeable cuts made to statutory payments throughout the 2000s.

Chart 1
FY2012 State Payments to Local Governments



Source: Michigan appropriation acts.

Michigan, like many other states, has a long history of sharing state-generated revenues with local units of government. State aid for schools is the oldest program, dating back to the early years of statehood. Initially, the state distributed the Primary School Fund

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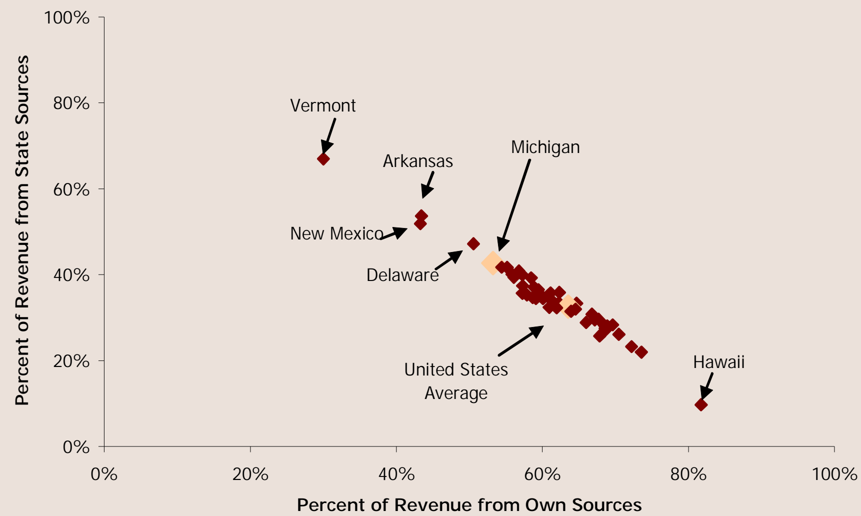
among schools based on the number of students in a township; these funds were supplemented with locally-raised taxes. The state began sharing nearly all of the retail liquor license tax receipts with cities, villages, and townships as unrestricted revenue sharing in the early 1930s. This was followed, in 1939, by sharing state intangibles tax on a per-capita basis with cities, villages, and townships, in exchange for the removal of intangibles property from local tax rolls. Over the years, the state developed a host of programs to share state revenues with all types of local governments.

The school finance reforms enacted in the mid-1990s materially changed Michigan's state-local intergovernmental fiscal relationships. The shift in funding responsibility for K-12 school districts (from local property taxes to state distributions) was large enough to increase the share of state payments made to *all* local governments, as a group, and decrease the reliance on local own source general revenues (taxes, fees, charges, etc). Prior to the reforms (in 1992), state payments accounted for 31 percent of total local government revenues and own source revenues made up 66 percent of the total. Immediately following the reforms (in 1996), the state-local mix changed to 50 percent and 47 percent, respectively.[1]

Also, the school finance reforms changed Michigan's rank among all states in terms of state-local fiscal relations. Today, Michigan local governments, as a group, rely on state shared revenues to a greater degree than local governments in other states to finance local services. Local government reliance on state shared revenues as a percentage of total general revenue for the 50 states is shown in **Chart 2**. For the most recent year (2009), U.S. Census figures reveal that Michigan local governments of all types and as a group received 43 percent of their total general revenue from state intergovernmental transfers, while 53 percent came from own source revenues (the remainder, less than 4 percent, came from federal intergovernmental transfers). Across all states, the split for local governments as a group was 33 percent from state shared revenues and 62 percent from own source revenues. In 2009, Michigan ranked fifth highest in the share of total local government general revenue coming from state payments (Vermont – 67 percent, Arkansas – 54 percent, New Mexico – 52 percent, Delaware – 47 percent).

Chart 2
Local Government Reliance on State Shared Revenue vs. Own Source Revenue by State



Source: U.S. Census Bureau, State and Local Government Finances, 2009

[1] U.S. Census Bureau, Annual Surveys of State and Local Government Finances. www.census.gov/govs/estimate

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For Michigan, as well as other states, these aggregate figures can disguise the experience for different types of local government. In the case of local school districts in Michigan, the U.S. Census reports that state revenue accounts for 54 percent of the total $19.4 billion revenue in 2010, a full 10 percentage points above the average figure for *all* Michigan local governments in 2010.

Similarly, the significance of state payments as a mechanism for funding services varies among individual units, even for local governments of the same type. Unrestricted statutory revenue sharing to cities, villages, and townships has been cut over the past decade to address state budget deficits. Only a fraction of these local governments (less than one-third) that received statutory payments in the early 2000s receive them today. Funding for statutory payments to cities, villages, and townships peaked at $684 million in FY2001 and stands at $225 million in the FY2013 state budget under the Economic Vitality Incentive Program (see below).

Michigan local governments' greater reliance on state resources compared to other states is a direct function of revenue-raising constraints (both as to types of taxes and tax rates) found in state law. While similar constraints exist in other states, the combination and stringency of the constraints in Michigan are unique. Local government revenue raising capabilities are constrained by property tax rate limits, by the constitutional requirement to get voter approval to raise property tax rates, by limited local income tax options (available only to cities), and by the absence of local options for sales, motor fuel, or other taxes. A recent report from The Pew Charitable Trusts found that of the 46 states that limit the local property tax, Michigan is one of three states (Arizona and Colorado) with all four types of property tax limitations (revenue limit, levy limit, rate limit, and assessment limit).[2] Michigan's system of sharing state revenues with local governments is very much a direct byproduct of these constraints and not necessarily the result of state government's willingness to share its resources with sub-state entities.

Given these constraints and the major role played by state payments in the finances of local governments in the aggregate, Michigan's revenue generation system is a highly centralized system. However, because of the substantial number of local governments (both general purpose and special purpose) in Michigan, the system is characterized as being extremely decentralized in terms of service provision.

Strong Constitutional Foundation

A foundational component of Michigan's state-local fiscal relationship is codified in the 1963 Michigan Constitution, adopted as part of the 1978 Headlee Amendment. The provision effectively establishes a minimum amount of state resources, or a funding floor, that the state must share with local governments each year. Article IX, Section 30 specifically prohibits the state from reducing the proportion of total state spending paid to all units of local government as a group below the proportion in effect in FY1979, which is 48.97 percent. Prior to the 1990s school finance reforms, the state was close to this constitutional funding floor, but the shift in financing responsibility from local districts to state taxes propelled the state far above the legal minimum. For the current year, the state is estimated to be nearly 10 percentage points above the floor. This percentage applies to local governments "taken as a group"; therefore, the state has the ability to shift payments among types of local units or among programs and services within specific local government types.

A related constitutional provision, also adopted as part of the Headlee Amendment (Section 29), prohibits the state "from reducing the state financed proportion of the necessary costs of any existing activity or service required of units of Local Government by state law." This means the state must maintain at least its current proportion of the necessary costs for those activities and services required of local governments by state law at the time of the Headlee Amendment. Thus, if the state was paying 50 percent of a state-mandated activity in 1978, it is required to continue to pay 50 percent in the future. This section is understood to apply to the statewide costs of a program, not the state share in each individual local government.

A corollary provision also contained in Section 29 prohibits unfunded state mandates. This means that if the state wants local units of government to engage in an activity or service they did not provide in 1978, or increase the level of any activity or service above what was required in 1978, then the state must provide 100 percent of the resources to cover the increased costs. Both sections of the Headlee Amendment (29 and 30) are important to consider when discussing the recent policy shift away from revenue distribution programs towards block grant programs for which local governments must qualify.

[2] The Pew Charitable Trusts, American Cities Project. "The Local Squeeze." June 2012. www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Local_Squeeze(1).pdf

The Case for Sharing State Revenues

The case for establishing intergovernmental fiscal relationships generally and sharing state revenue with local governments specifically is premised on a number of reasons. Revenue sharing programs address different policy objectives and sometimes a single program can pursue multiple objectives at the same time (e.g., diversifying the local revenue base and redistributing resources). Many of the reasons for sharing revenue have an economic justification. Revenue sharing programs are justified on the grounds that, in some cases, state laws preempt certain local taxes and revenue sharing payments help to fill the resultant void. Shared revenue is used to improve the diversification of local government revenue structures so that they are not overly dependent on a single source, such as the property tax. Revenue sharing has been used to promote property tax relief to taxpayers. While these are the primary reasons for instituting revenue sharing, the specific justification(s) for each of Michigan's sharing programs varies.

An economic argument proffered for state aid is grounded in efficiency claims; substituting the state tax system (granting government) for a local tax system (recipient government) can generate efficiency gains if the administrative costs of the statewide system are lower than the combined costs of multiple local taxing mechanisms. The revenue collected under the state system is returned to local governments based on where the tax is collected. In addition to the local governmental units, taxpayers and business firms also benefit from increased administrative efficiency. They benefit from the ease of dealing with a single taxing jurisdiction as opposed to multiple ones.

Michigan does not employ a revenue sharing model that substitutes a local tax for a state-level tax and that attempts to redistribute all the funds back to locals on a dollar-for-dollar basis. The state does use the amount of vehicle registration tax collected in each county to return a portion of the combined state motor fuel tax and vehicle registration tax to county road agencies. In lieu of a host of sub-state taxing schemes, state fuel and vehicle registration tax receipts are shared with local road agencies to cover road maintenance and improvement costs. In addition to the amount of tax collections in each jurisdiction, revenues are shared based on highway mileage, per-capita, and equal shares.

Another economic justification for state grant programs is to correct for market failures in the provision of public services. State payments are justified as a method to ensure that a sufficient amount of a public service is provided in a local community where nonresidents might enjoy the service but are not responsible for directly financing the service (i.e., they do not pay local taxes). State aid can be used to address this "externality" by inducing recipient governments to produce more of a service, up to the amount required to be efficient. Grant programs, such as those for public safety, are usually structured as matching funds (as opposed to lump sum) in order to reduce the marginal cost of service to the providing government. Ideally, the grant amount is set equal, or as close as possible, to the marginal benefit received by the nonresident.

Major Michigan state revenue sharing programs are generally unrestricted in nature (e.g., K-12 state aid, unrestricted aid to locals, road funding) and do not require a local match.[3] This contrasts with many federal-state revenue sharing programs where the federal government utilizes matching funds as a mechanism to incent certain behavior they want states to engage in. For example, federal road and bridge funds are distributed to states based on their ability to provide a match. On the other hand, local road agencies in Michigan do not have to match the state motor fuel and vehicle registration tax receipts distributed pursuant to Public Act 51 of 1951.

State collected revenues can be used as a mechanism to redistribute resources among regions for equity or political reasons. State funds can be used to equalize the ability of local governments to provide services, and ensure that a minimal or acceptable level of services is provided statewide – a state objective. State taxes can be shared on a formula basis inversely proportional to local wealth, e.g., based on property or income. This results in resources being shifted, at least indirectly, from residents in wealthier communities to residents in lower-income communities. The development of Michigan's current K-12 education finance system was premised, in part, on the desire to

[3] Technically speaking, local school districts are required to levy the 18-mill non-homestead property tax to be eligible to receive K-12 state aid, thus serving as a match.

equalize per-pupil spending across districts and to provide more state aid to poorer districts.

Another reason for revenue sharing programs is to promote property tax relief. Unrestricted state funds deposited in a local government's general fund can be used interchangeably with property tax receipts to fund local needs. Unrestricted state aid arguably holds down or reduces property taxes in the recipient jurisdiction. This can result in reduced property tax rate differences that otherwise would exist among local governments, which can lead to increased economic development activity in the recipient unit. The reduction in tax rates and increased activity in the recipient jurisdiction may be offset by the loss of economic activity in those jurisdictions that were previously tax-advantaged. From an economic development standpoint, the net result may be neutral when all jurisdictions in a state are considered.

State shared revenues diversify the local revenue base by making available a revenue source that a local government may be prevented from accessing because of state limitations. For example, local governments in Michigan are preempted from levying sales tax, but state payments from state sales taxes diversify the local tax structure. Furthermore, this distribution can improve overall equity because state sales tax revenues are not returned to the communities where they are collected.

Finally, sharing state funds with units of local governments can be premised on the fact that local units of government have been prohibited from levying certain taxes. States preempt local taxation authority to reduce unevenness in tax base among local jurisdictions and to reduce the competitive disadvantages that may face businesses in higher tax jurisdictions. Beginning in FY1977, with the removal of inventories from the personal property tax base and the enactment of the Single Business Tax (SBT), state aid payments were made to locals from SBT revenues to offset the revenue loss resulting from the inventory exemption.

Perhaps the most frequent criticism leveled against state revenue sharing programs involves the loss of accountability that accompanies any intergovernmental grant-in-aid program. This is most applicable with unrestricted revenue sharing programs, and less so with restricted (e.g., transportation) revenue sharing programs because there is a more direct linkage between the state funds (e.g., motor fuel tax) and the local spending (e.g., road maintenance). One tenet of public finance generally holds that the costs associated with raising revenue should be accompanied by the responsibility of spending it.

Another criticism is that states will be deemed responsible for local tax increases or service cutbacks when state funding is reduced in response to a decline in state revenue collections. Whether shared revenues fall because of economic forces, policy preferences for lower state taxes, or claims elsewhere for state budget resources, state governments can be portrayed as responsible for upsetting local budget plans.

A New Chapter in Michigan's Evolving History of State Revenue Sharing

Michigan's approach to sharing state revenues with local governments is constantly evolving. The school finance reforms in the mid 1990s modified the state-local fiscal landscape significantly. State policymakers in 1998 adopted major modifications to the second largest revenue sharing program at the time, $800 million of sales tax revenue statutorily shared with cities, villages, townships, and counties. The changes took effect in FY1999, but because of Michigan's chronic state budget challenges throughout the 2000s, the new distribution formulas were never fully implemented nor did the program ever receive the full statutorily-dedicated funding amount. Because of the state budget troubles, the new formulas were abandoned in the early 2000s and statutorily expired after FY2007. Between FY2008 and FY2011, statutory payments were governed by provisions written into annual state appropriation acts. The FY2012 budget marked a new chapter in Michigan's revenue sharing history, this time by eliminating the statutory payments to cities, villages, and townships, and replacing them with payments conditioned on these local governments meeting certain criteria established by the state.

Policy Shift: A Case of "Erase and Replace"

The origins of the budget policy shift away from a distribution program to incentive-based funding dates back to the early months of Governor Snyder's administration. Although the Governor's FY2012 Executive Budget, released in mid-February 2011, contained elements of the shift (including appropriation recom-

mendations), the details were not released until one month later. On March 21, 2011, Governor Snyder delivered a message to the legislature that laid out his vision for reforming the interaction between the state and local governments; identified some reforms of laws that affect local governments; and announced plans to transform the unrestricted state revenue sharing program into an incentive program to push local governments into implementing certain policies. Elements of this message, combined with the Governor's budget proposal, formed the basis for the creation of the Economic Vitality Incentive Program (EVIP) by the Michigan Legislature and the cessation of unrestricted state revenue sharing to cities, villages and townships.

EVIP Design & Components

The new EVIP effectively erased the statutory component of the unrestricted state revenue sharing program (constitutional per-capita payments were unaffected) and replaced it with an incentive program through which funding flows to cities, villages, and townships based on their ability to satisfy certain criteria. Although erased, the EVIP relies on the old statutory program to determine participation and individual payment amounts. The total amount available in FY2012 ($210 million) represents a reduction of roughly one-third from the statutory payment amount authorized in FY2011, thereby helping address the projected state budget deficit in FY2012.

This reduced funding total is intended as a "carrot" for units that previously received state revenue sharing without having to meet the state-identified criteria. For FY2012, the qualification criteria, total funding, and distribution formulas, are authorized under Public Act 63 of 2011 and Public Act 107 of 2012 (appropriations acts). Unlike other state laws, appropriation acts and the conditions contained therein are effective for a single fiscal year (October 1 through September 30). Thus, the FY2012 EVIP provisions will expire September 30, 2012. Each year, the legislature will have to decide whether the program will continue, the amount of funding available, and what the design of the program will be. Using an appropriation act to authorize the program creates a level of uncertainty that might not exist if the program were included in regular statutory law. The EVIP, like its predecessor, is subject to appropriation risk.

Throughout the 2000s, state budget cuts to the statutory program reduced the number of units receiving payments, although all continued to receive their per-capita constitutional payment. Only those units that received a FY2010 statutory payment greater than $4,500 are eligible to receive a FY2012 EVIP payment. The EVIP payment is capped at roughly 68 percent (73 percent in FY2013) of the FY2010 amount. Based on the qualification criteria, about one-third of approximately 1,800 cities, villages, and townships are eligible for EVIP.

State law divides the $210 million EVIP pot equally between three criteria ($70 million each). Eligible local governments have to satisfy the three criteria separately and independently to receive their full EVIP allocation. Thus, a local government only meeting one of the criteria receives one-third of the total funding for which it is eligible.

Broadly defined, the three criteria that must be met by locals to qualify for EVIP funding include: [4]

1) publication of accountability tools, including a performance dashboard and citizens' guide to financial information;
2) development of plans to increase cooperation, collaboration, and/or consolidation with other local governments; and
3) development of a compensation plan for new employment and collective bargaining agreements that limit retirement benefits for local government employees and prescribe a minimum health care premium cost-sharing arrangement for current employees. Alternatively, units can qualify for the third pot of funding through compliance with the Publicly Funded Health Insurance Contribution Act (Public Act 152 of 2011), which generally caps the amount of health care premium costs that public employers are allowed to pay for.[5]

[4] General background information and greater detail regarding the specific EVIP criteria is provided in the CRC Memorandum *Local Government Performance Dashboards and Citizens' Guides* (September 2011).

[5] Specifically, PA 152 creates hard caps on the amount a public employer may contribute to medical benefit plans for its employees. The cap amounts vary based on coverage type and take effect with the next collective bargaining agreement. The Act also provides employers with an option to elect an 80 percent contribution cap in place of the hard cap. Electing this option requires a local unit to garner a majority vote of its governing body. By a two-thirds vote of a unit's' governing board, the local unit can exempt itself from the requirements of the Act.

Issues Raised with EVIP

A central question arises about the changes to Michigan's state revenue sharing program, "If the state wants local governments to change their behavior, why not just pass a new law requiring all of them to engage in the desired activity? Why eliminate an existing program and replace it with something nearly identical, but with the added requirements?" The answer lies in the constitutional prohibition against unfunded state mandates (Article IX, Section 29). Simply mandating local governments to change compensation plans, adopt accountability tools, and engage in inter-local cooperation would entail new costs, possibly substantial costs. With a flat mandate, the state government could be financially responsible for these additional costs as required by the Headlee Amendment to the Michigan Constitution.

By taking an "erase and replace" approach, the state technically avoids running afoul of the constitutional prohibition. Because statutory unrestricted revenue sharing was not tied to existing local government activities or services mandated by the state, and because the funding was not constitutionally protected, state policymakers were free to abolish the program and replace it with the EVIP without running afoul of the Headlee Amendment. While the state's actions to erase statutory revenue sharing and replace it with EVIP conform to the letter of the Michigan Constitution, they certainly raise questions as to whether the intent and spirit of the Headlee Amendment are being skirted. While the constitutional issues surrounding EVIP may be fairly settled, other issues are worth considering.

"Whose objectives are being met?" This lies at the heart of current policy shift. Through the EVIP, the State of Michigan is trying to incentivize local governments to engage in certain behavior(s) that they might not otherwise. These behaviors are designed, primarily, to meet the goals and objectives of state policymakers; they may, or may not, be consistent with the policy choices and directions chosen by local officials. In some instances they do align, but that is not universally the case. To the extent that eligible governments change their behaviors, state policy goals are met. Ultimately, it will remain a local decision whether to comply with the EVIP criteria; however, a decision to comply could be interpreted as placing state objectives ahead of local ones.

The new program eliminates the previous statutory revenue sharing program; however, it limits participation to those units that received payments under the old program. This was done to avoid causing fiscal stress to those units that previously received state payments since creating a new program and expanding eligibility would reduce the funds available to the units already participating. Limiting the use of incentive funding to a predetermined subset of local governments raises concerns about the efficient use of limited state budget resources to further a statewide policy objective. A wholly new incentive program would be open to all local governments; however, by capping participation in the EVIP, the state will be unable to provide financial incentives to nearly two-thirds of local governments for pursuing the sought-after behaviors. We will never know if the local governments excluded from the EVIP would have been incented to change their behaviors.

Another concern about the use of limited state budget dollars arises from the fact that some eligible locals may have already engaged in the desired behaviors. In such cases, the EVIP funding essentially comes without any changes in behavior. Similarly, various local governments have pursued cooperative, collaborative and consolidation efforts to control costs without adversely impacting service levels. For example, a 2012 report by The Center for Local, State, and Urban Policy (CLOSUP) at the University of Michigan examined the effectiveness of EVIP at increasing intergovernmental collaboration.[6] The report found that "most local governments were already engaged in joint service sharing efforts, and most were already looking to expand those efforts on their own, before the introduction of EVIP." Given this finding, it could be argued that the limited state funds going to EVIP-eligible units for this activity could have been more efficiently employed to incent the behavior of those governments that were not previously engaged in collaborative efforts. This would require that the program be opened up to a broader population of local units, not just those receiving statutory payments in the past. Going forward, determining the degree to which incentive payments for other activities resulted in behavior modification will be difficult because the state has no way of knowing whether a local government was already engaged, or planning to engage, in the desired behavior.

[6] University of Michigan, Gerald R. Ford School of Public Policy, The Center for Local, State, and Urban Policy. "State funding incentives foster local collaboration, but also raise concerns." March 2012. www.closup.umich.edu

Another issue with the EVIP is the fact that it is not a true incentive program. Eligible participants receive a set amount of funding (68 percent of their FY2010 statutory payment) for meeting all criteria in full. For each pot of money available, meeting the EVIP conditions is basically an all or nothing proposition. A unit is unable to receive more resources if it engages in more of a desired activity and does not receive a fractional payment if it only meets part of the criteria. For example, a local unit that developments a citizens' guide to financial information, but does not produce a performance dashboard, will not receive any part of the allocated funding. Similarly, units that require their employees to pick up larger shares of health insurance premium costs (greater than 20 percent) can not receive additional EVIP funds.

If the goal of state policymakers is to change behaviors of *all* local governments, EVIP will not succeed because only about one-third of Michigan's cities, villages, and townships are eligible to receive payments. The majority of those eligible to receive funding are cities, despite the fact that townships outnumber cities and villages by a factor of more than two. Again, this is a function of using the old statutory revenue sharing program to determine eligibility. Generally speaking, cities tend to provide a more diverse menu of services and tend to have more complex finances compared to townships and it may be the case that state policy is aimed at changing the behavior of cities by targeting the incentive funding. This is not directly stated in the EVIP legislation, but it may be inferred.

While nothing prevents the non-eligible local governments from engaging in the desired behaviors, there is no financial incentive to do so. Whether other governments see the utility in providing these accountability tools, want to be in position for future EVIP funding, or react to pressure from their citizens to keep up with neighboring communities, such actions will be completely voluntary.

The switch to incentive funding from a system of unrestricted payments can have consequences that are contrary to the original intent of sharing state revenues. As previously noted, state governments can engage in sharing programs to accomplish a number of objectives (tax structure equalization, economic development, minimum service levels, government efficiency). To date, actions required to receive state incentive funding have not been overly onerous. A good deal of flexibility and state assistance has been provided to help locals qualify for funding. However, the continued use of incentive funding paired with different conditions (e.g., more onerous and costly) and requirements (e.g., inconsistent with local citizens' wishes) might cause local units to forego the funding. If local governments find new conditions needed to receive revenue sharing to be too onerous and choose not to participate, not only will state policymakers fail to achieve the benefits of the new program, but state policymakers will also lose the benefits they were previously achieving from the revenue sharing program before they attached the conditions. This can jeopardize the broader goals of establishing a revenue sharing program in the first place. Some units may be able to forego the state dollars and absorb the loss within current budgetary structures with little impact to local taxpayers; however, for others, the lost funding will be recognized in much more tangible ways by taxpayers – reductions in services or increased taxes. Widespread and disparate service cuts and/or tax increases across Michigan local governments will, in turn, result in the conditions that called for revenue sharing in the first place.

Encouraging Schools to Adopt Best Practices

The policy shift towards incentive funding is not limited to the unrestricted state revenue sharing program for cities, villages, and townships. State policymakers adopted a new program for FY2012 to encourage local school districts (both traditional public as well as charter schools) to engage in certain financial best practices in exchange for additional state funds. While the specifics are different from the EVIP, the general premise is the same – offer state financial incentives to encourage local governments to change their behavior so that it better aligns with state policy goals and objectives.

Amendments to the State School Aid Act for FY2012 created the new categorical program to provide $100 per pupil to local school districts that meet at least four of five financial best practices. These state dollars are being provided outside of the traditional state aid mechanism where school districts receive the majority of their funding (per-pupil foundation grant). Qualifying for the incentive dollars requires schools to engage in certain behaviors, but once received, the funds can be used for any purpose, similar to the foundation grant. The five best practices include:

1) charge current employees at least 10 percent of the health care premium;
2) establish the district as the policyholder of health insurance plans;
3) develop and implement a service consolidation plan;
4) obtain competitive bids on non-instructional services; and
5) provide accountability tools, such as a dashboard or report card with specific indicators.

A few key differences merit consideration. The financial best practices funding represents a much smaller proportion of the total amount of state revenue shared with K-12 schools, when compared with the complete elimination of the statutory revenue sharing program in exchange for the EVIP. In FY2012, the state will provide at least $6,846 per pupil in unrestricted state aid (foundation grant) to each school district. The new incentive funding is $100 per pupil, about 1.5 percent of the minimum grant. Also, the financial best practices funding for schools is established as a separate categorical rather than being included in the foundation grant. Additionally, *all* school districts are eligible for the new funding, not just a subset, which presently is the case for local governments.

The financial best practices represent the thinking of state policymakers and not necessarily the goals and objectives of local school board members, administrators, and professionals. While they might align with some locals' desires to control costs, engage in cooperative activities, or another best practice, this is not universally the case. Again, the incentive funding, at least indirectly, erodes local control.

Qualifying for the additional $100 per-pupil funding is an all or nothing proposition for K-12 school districts; either a district meets four of the five criteria or they do not. All of the funding hinges on full qualification, as opposed to providing a range of funding based on meeting some, but not all, of the best practices. The EVIP allows local governments to meet the state-identified criteria separately and individually to receive funding, which honors the authority of local decision makers to a slightly greater extent than the K-12 incentive funding.

Schools are not required to maintain the financial best practices in their current form, beyond FY2012 because the money and the qualification criteria are specific to one year. If the funding and the requisite qualifying conditions are included in future budgets, then the practices might be maintained on an ongoing basis. The state incentive funding may be effective at changing behaviors over the very short term, but it remains to be seen whether it will be effective over the long term or permanently. If policymakers desire to affect the long-term behaviors of local school districts, then they may have to reauthorize the program. Allowing school districts to abandon the financial best practices defined by the state after a single year is probably not the most efficient use of limited state resources.

FY2013 Budget Expands Use of Incentive Funding

At the urging of Governor Snyder, the use of incentive funding will be continued in FY2013 and expanded to other entities. The Governor's Executive Budget expanded the practice to counties and intermediate school districts. The Legislature included incentive programs for these entities in the final appropriation bills sent to the Governor, although final funding amounts and conditions varied from the Executive Budget.

While the requirements to qualify for funding and the conditions that must be met to receive funding vary, these new programs follow the same basic theme behind the FY2012 policy shift – moving from a revenue distribution program to a block grant for which local governments must qualify. Also of note, the EVIP and the best practices for K-12 school districts would be modified in FY2013 in terms of funding amounts and conditions that must be met to receive funding. **Table 1** (next page) summarizes the expanded use of incentive funding programs, as contained in the FY2013 budget.

Table 1
Incentive Funding Program in State of Michigan Budget, FY2012 and FY2013
(Dollars in Millions)

Program	Eligible Recipients	FY2012	FY2013
Economic Vitality Incentive Program (EVIP)	Select cities, villages, townships	$210	$225
County Incentive Program	Select counties	NA	$26
Best Practices	All traditional public school districts and charter schools	$154	$80
ISD Best Practices	All intermediate school districts	NA	$2

The Elephant in the Room: Local Control

The recent changes to state revenue sharing programs raise questions about local control and the distinction between statewide and local concerns. The concept of home rule involves a general grant of rights and powers to local governments, subject only to certain enumerated restrictions. This contrasts with a governance structure where state government grants local governments with enumerated rights and specifies powers. Under this system, the authority of local government is handed down by state law. Michigan operated in this manner prior to the 1908 Michigan Constitution where state government was responsible for local government and the delivery of municipal services. Home rule powers, enshrined in the 1908 Michigan Constitution and expanded in the 1963 Michigan Constitution, permit the people to structure their charter units of government and to determine local regulations and ordinances in a way that best reflects the needs of the community. Although Michigan is considered to be a state with a strong history of, and support for, local home rule, concerns over local control still persist. The current discussion is one such example.

Although the broad budget policy shift and the accompanying program changes are within the legal scope of the state constitutional provisions concerning home rule (Article VII, Sections 2, 21, 22, and 34) and intergovernmental fiscal relationships (Headlee Amendment), in some instances, they seem to tread on the spirit of the law.[7] Consider the example of the EVIP requirement that local governments must ensure that their compensation plans contain specific provisions regarding employee pension and health insurance benefits. These provisions are borne out of state concerns about the fiscal health of local governments and their ability to control and reduce costs. State policymakers see local units, as a group, as unable or unwilling to address the fiscal concerns. By tying key state resources to conditions that are designed to help local governments with these concerns, policymakers are hopeful that the local fiscal challenges will be addressed. However, this comes at the expense of local decision making and the ability of local governments to prioritize their own spending.

Furthermore, the policy shift comes at a time when state tax collections appear to have stabilized after a near decade-long slide where state distributions to local governments have been reduced. Local governments are seeking restoration of previous state revenue sharing cuts. Instead of restoring state payments to previous levels and through existing programs, state policymakers are using the additional state shared resources to change the behaviors of local governments by attaching new strings as a condition of receiving funds. These behaviors are intended primarily to better align with state policy goals and objectives, not necessarily local ones. They attempt to direct local government behaviors that, absent the state funding, would entail decisions completely reserved to local residents and elected officials.

[7] These sections provide home rule authority for counties (Section 2); authority for cities and villages to tax and issue debt, within state limits (Section 21); home rule authority for cities and villages (Section 22); and state that the intent of these provisions is to presume that power rests with the local governments.

Conclusion

State policymakers control the purse strings to resources that local governments rely upon to provide services. In some cases, state funding accounts for a substantial portion of an individual local government's overall budget. Various state revenue sharing programs received cuts, some significant, during the 2000s to help address state budget challenges and in response to declining state tax collections. At the same time that state officials cut state funding for local governments, few state revenue sharing programs have undergone fundamental design changes. This changed recently with the end of the Great Recession and with the general improvement in the state's budget picture.

Beginning with the FY2012 state budget and expanding to next year's budget, policymakers have made significant changes in how state resources are shared with local governments. They adopted new budget policies that attach strings to these resources in order to advance state public policy goals and objectives. These goals and objectives, however meritorious on their own, may not be consistent with those of the local governments. The rationale offered by state officials is that the changes are designed to assist local governments with their challenging fiscal decisions and to increase accountability and transparency at the local level generally, not just for the state shared revenues. These changes have been incorporated into budget language, as opposed to statutory provisions governing the distribution of state revenues. Policymakers intent on continuing to use of incentive funding may want to consider solidifying the programs in statute in order to effect desired behaviors over the longer term.