CRC Special Report

Michigan Constitutional Issues

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Article IX – Finance and Taxation

In Brief

At the November 2, 2010 general election, the voters of Michigan will decide whether to call a constitutional convention to revise the 1963 Michigan Constitution. The question appears on the ballot automatically every 16 years as required by the Constitution. The Constitution provides that a convention would convene in Lansing on October 4, 2011. If the question is rejected, it will automatically appear on the ballot again in the year 2026.

The Citizens Research Council of Michigan takes no position on the question of calling a constitutional convention. It is hoped that examination of the matters identified in this paper will promote discussion of vital constitutional issues and assist citizens in deliberations on the question of calling a constitutional convention.

The power to tax and the disposition of the revenues collected involve two of the essential characteristics of civil government. This analysis examines several provisions in Article IX, "Finance and Taxation," of the Michigan Constitution and issues related to them that a constitutional convention might consider: state and local tax limitations; state tax structure; local tax structure; pension and other post-employment benefit funding; state borrowing; and, earmarking of state revenues for specific public programs. Neither the list of foregoing issues nor the presentation that follows is intended to be exhaustive.

Introduction

Article IX has been the subject of the most attempts to amend the Constitution (29 proposed amendments), indicating the importance of the issues contained therein. The article has been successfully amended 10 times, most recently in 2006. The two most significant amendments were Proposal E of 1978 (Headlee Amendment) and Proposal A of 1994; both dealt with multiple sections and both created tax and/or spending limitations.

Constitutional Convention Issues

A key purpose of a state constitution is to limit the governmental power of the state. That principle is of particular importance with respect to the power of the government to tax and the interest of the people to limit that power. Article IX, "Finance and Taxation," of the Michigan Constitution contains various limitations upon the otherwise plenary power of the legislature. These limitations range from prescribing the proportion of value at which property may be taxed, to requiring voter approval before units of local government may increase certain taxes and indebtedness, to limiting the forms and rates of taxation (state and local), to specifying how the revenues from certain taxes are to be expended. Many of these provisions were contained in the Constitution when it was adopted, while others were added subsequently through amendments approved by voters.

The level of detail which the constitution should contain with respect to taxation was an area of considerable disagreement at the 1961 Constitutional Convention. Many delegates believed that the Legislature should be free to determine the level and type of taxation as circumstances arose, while other delegates expressed the view that the Legislature should not be allowed complete discretion. In the end, convention delegates agreed to provide the Legislature with a "power of the purse" that is bound by consti-

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tutional limitations pertaining to the type of taxes that may be employed and the rates of certain taxes that may be levied. Subsequent amendments to the Constitution added further limitations to this foundational legislative power. A new convention might begin by reexamining this fundamental question about the proper role of the state constitution relative to the Legislature's "power of the purse."

In addition to the broad concerns surrounding the level of detail contained in Article IX that a constitutional convention would be expected to address, Article IX contains several specific provisions upon which a convention might wish to focus its attention.

State Tax and Revenue Limitations

With the exception of the limitations placed on it by the Constitution in Article IX, the Michigan Legislature unilaterally exercises the "power of the purse" without limitation when it comes to state fiscal matters. While often thought of as a single power, the "power of the purse" consists of two distinct, but related, powers designed to serve as a check and balance between the legislative and executive branches of government. Through the power to tax (Section 1), the Legislature is able to transfer economic resources from individuals and businesses to the state government to finance public goods and services and to redistribute wealth among individuals and private entities. This power is the sole province of the legislature and cannot be "surrendered, suspended, or contracted away" (Section 2). The logical complement to the power to collect taxes is the power to direct state spending through appropriations, which also rests entirely with the Legislature (Section 17). Combined, the power to tax and the power to appropriate provide the legislative branch with the authority to command and guide state financial resources.

Prohibition on Graduated Income Taxes

A graduated or "progressive" income tax taxes higher income earners at proportionately higher rates than lower income earners. Section 7 prohibits the imposition of an income tax, graduated as to rate or base, by the state or any of its subdivisions. This provision was new to the 1963 Constitution. For all practical purposes, this provision has effectively served to limit income taxes levied at both the state and local level, and levied on both individual and business income, to those that involve a single or "flat" rate. This provision neither requires an income tax nor does it limit the maximum rate allowed if such a tax is authorized by the Legislature. These decisions are left to the discretion of the Legislature.

While the "flat" tax rate requirement of Section 7 is fairly straightforward, the section's prohibition on a "graduated" tax base is less clear. Statutory implementation of an income tax, whether for individuals or for businesses, can have the practical effect of graduating the tax base. Michigan currently uses federal Adjusted Gross Income (AGI) together with various credits and exemptions to determine the basis of taxation, effectively resulting in a "graduated" state income tax base. During the 1961 convention, there was considerable discussion about the use of federal AGI in light of the proposed new language; however, the convention delegates noted that federal AGI could be used without violating the constitutional provision. The delegates also discussed the implications of the use of credits and exemptions in light of the new prohibition and believed that the legislature could prescribe their use. Over time, Michigan courts have upheld the use of exemptions, exclusions and credits, but

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on the grounds that they apply to all taxpayers without regard to income. However, it is noteworthy that the Legislature also has enacted exemptions which are based upon income. The amount of the homestead property tax credit is based on the income of the tax filer, as is the amount of the earned income tax credit that a taxpayer can claim. [Note: Although the homestead property tax credit is applied against income tax liability, the credit is designed to provide property tax relief and therefore some contend that it cannot violate the Section 7 prohibition.]

The prohibition against a "graduated" income tax was a contentious issue for a period of time following adoption of the new constitution. Proposals to allow graduated income taxes were defeated in 1968 (Proposal I), 1972 (Proposal D), and 1976 (Proposal D). In recent years the issue has reemerged in the public policy debate in Lansing. Elimination of the restriction has been proposed to address the state's ongoing structural budget deficits. With the same level of income growth, revenues from graduated income taxes can grow faster than the revenues from flat rate taxes if incomes grow faster for high income taxpayers than for lower income taxpayers, which has been the case in recent years.

According to the Federation of Tax Administrators, as of January 2010, Michigan was one of seven states (Colorado, Illinois, Indiana, Massachusetts, Pennsylvania, and Utah) that had a broad-based "flat" rate individual income tax rate. [Note: The 2010 Michigan individual income tax rate is 4.35 percent.] Thirty-four states that have an individual income tax use a graduated rate system and the rates vary from a low of 0.36 percent in Iowa to a high of 11 percent in Hawaii. In addition, the number and range of the various tax brackets used in each state differ markedly, although most have between three and five brackets. Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not have an individual income tax and two states (New Hampshire and Tennessee) only apply the tax to dividend and interest income.

A constitutional convention would have an opportunity to revisit the prohibition on graduated income taxes and to consider factors that affect uniformity of the tax base. A convention would likely consider the issue in light of the fiscal challenges facing state and local governments and the potential for a graduated income tax to increase tax yields.

Limitations on Sales Taxation

While the current six percent state sales tax is often viewed as a single tax, it is actually two separate taxes – a discretionary tax and a mandatory tax. Section 8 limits the rate of the sales tax on gross taxable sales of tangible personal property to four percent and requires the levy of an additional two percent tax on gross taxable sales. Authorization for the legislature to levy the discretionary tax, at a rate of up to four percent, mirrors the language that was included in the 1908 Constitution and carried forward to the 1963 Constitution.

Under the General Sales Tax Act, the legislature has authorized a discretionary tax at a rate of four percent, with 60 percent of the proceeds constitutionally earmarked to the School Aid Fund and 15 percent of the proceeds constitutionally earmarked for distribution to cities, villages, and townships, on a population basis. The mandatory two percent tax was added by amendment in 1994 (Proposal A) and is authorized in the General Sales Tax Act. All proceeds from the mandatory tax are dedicated in Section 8 to the School Aid Fund.

According to the Federation of Tax Administrators, as of January 2010, all but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) levied a statewide sales tax, with rates ranging from four percent (seven states) to 8.25 percent (California). Twelve states, including Michigan, levied the tax at a rate of six percent.

The current limitations on the sales tax rate are likely to be considered in light of the state's ongoing fiscal challenges to balance annual budgets and the desire to levy local-option sales taxes (discussed below).

State Revenue Earmarking

Earmarking, or dedicating revenues, refers to the practice of reserving revenues from specific sources for specific functions. In the absence of such revenue res-

ervations, resources flow to a government's general fund to be allocated through an appropriation process. Earmarking may occur as a fixed dollar amount or as a percentage of the revenues from a given source. In Michigan, earmarking occurs through both statutory provisions, which can be modified by the Legislature, and through constitutional provisions that require a vote of the people to alter. Constitutional earmarking is the most restrictive form and effectively limits the discretion available to the Michigan Legislature in exercising its "power of the purse" with respect to authorizing appropriations.

Article IX contains many earmarking provisions that dedicate specific percentages of revenues from different taxes to a variety of functions (See **Table 1**).

In addition to earmarking state taxes, other state revenues are controlled by constitutional earmarking provisions including various fee revenue for natural resources, state parks, and recreation purposes (Sections 35, 35a, 40, 41, and 42). In some cases, earmarking creates a separate, unique state fund (e.g., trust fund) for the purposes of receiving specific revenues and the use of the revenues is strictly controlled by constitutional language.

Some of the current earmarking provisions pre-date the 1963 Constitution and were incorporated, or expanded, in the new document. Other dedications have been added to the current constitution through amendment, with much of the amendatory activity occurring between 1994 and 2006. In terms of the amount of revenue associated with the various provisions, the majority of the dollars earmarked pertain to provisions included in the original 1963 document.

A high level of earmarking, both constitutional and statutory, contributed to the calling of the 1961 Constitutional Convention. In the years immediately preceding the new constitution, upwards of 70 percent of Michigan state tax receipts were dedicated to specific purposes, either through law or the Constitution. Following the adoption of the new Constitution and by the late 1960s, this figure dropped to around 45 percent. Gradually, the amount of state tax revenues dedicated to specific purposes declined and remained in the 40 percent range. The school finance reforms of the mid-1990s (Proposal A of 1994) in-

Table 1
State Tax Constitutional Earmarking Provisions and Fiscal Year 2009 Collections
(Dollars in Millions)

Tax	Earmark / Purpose	Total FY2009 Collection	Earmarked Amount
Sales Tax			
4% rate (Sec. 11)	60% - schools	$4,083	$2,450
4% rate (Sec. 10)	15% - cities, villages, and townships	4,083	612
2% rate (Sec. 8)	100% - schools	2,042	2,042
Use Tax			
2% rate (Sec. 8)	100% - schools	431	431
Gasoline Tax (Sec. 9)	100% - transportation	837	837
Diesel Fuel Tax (Sec. 9)	100% - transportation	95	95
Vehicle Registration Tax (Sec. 9)	100% - transportation	841	841
Minor Transportation Taxes (Sec. 9)	100% - transportation	20	20
Tobacco Products Tax (Sec. 36)	6% - health care	NA	NA

Source: Michigan Department of Treasury, *Annual Report of the Michigan State Treasurer FY2009*; CRC calculations

creased the level to closer to 60 percent and the level has fluctuated little since that time. Today, about 60 percent (34 percent through the Constitution and 26 percent via state law) of the total state tax revenue ($23 billion FY2009) is earmarked and outside of the full control of the Michigan Legislature.

State Revenue Limit

In addition to the restrictions placed on individual taxes and the disposition of certain tax proceeds, Article IX also contains an overall state revenue limitation each fiscal year (Section 26), set to a fixed percentage (9.49 percent) of state personal income. This first-ever Michigan state revenue limit was added to the 1963 Constitution as part of the Headlee Amendment in 1978, which added ten new sections (25 through 34) to Article IX and amended section 6. The revenue limit generally has been noncontroversial, chiefly because it was imposed when state revenues as a percentage of personal income were at a peak. Section 26 authorizes an adjustment in the revenue limit when programs are transferred between governmental levels by constitutional amendment. Proposal A of 1994 transferred a substantial amount of school finance responsibility from the local level to the state. However, Proposal A did not specify that an adjustment in the revenue limit was authorized.

In FY2009, state revenue collection subjection to the Section 26 limitation was $7.7 billion below the constitutional cap. Since the transfer of the majority of education funding responsibility to the state in 1994, the revenue cap has been exceeded in three years. The first time was in FY1995, following the full implementation of the new school financing system that relied on increased state taxation in exchange for a reduction in local property taxes. The revenue limit also was exceeded in FY1999 and FY2000, due in large measure to the strength of the state economy and attendant revenue collections. [Note: In each year the cap was exceeded, the amount was less than the one percent threshold included in Section 26 that requires pro-rata taxpayer refunds of the excess revenue. The excess revenue was deposited in the state's rainy day fund.]

In addition to considering continuance of such a limitation, a constitutional convention might wish to determine whether a proposed constitutional amendment which transfers governmental programs between levels of government must specify whether the revenue limit is to be adjusted.

State Borrowing

Establishment of provisions to limit state borrowing in the interest of protecting the credit of the state has been a topic of discussion at every constitutional convention since 1835. The topic of borrowing is covered extensively in the 1963 Constitution, including limits on the type of borrowing the state can engage in, requirements for voter approval, and a limitation as to the amount of debt that may be issued. The basic limitation on state debt is contained in Section 12, "No evidence of state indebtedness shall be issued except debts authorized pursuant to this constitution." A constitutional convention would likely examine the state's borrowing experience in light of the operation of several constitutional provisions authorizing the issuance of debt.

General Obligation Debt

Section 15 and Section 16 provide limitations on the issuance of long-term general obligation debt, the repayment of which is backed by the pledge of the full faith, credit, and taxing powers of the state. Section 15 provides that the state may borrow money pursuant to an act passed by two-thirds of the members in each house of the Michigan Legislature and subject to the approval of the people as to the purpose of the debt, the amount, and the method of repayment. Section 16 (discussed further below) provides the state with the authority to issue debt for the purposes of making loans to school districts. As of September 30, 2009, a total of $1.7 billion in general obligation debt was outstanding.

Voter Approval

General obligation debt is different from state non-general obligation debt, which is issued pursuant to sections 9 and 13, in two

important ways. First, whereas general obligation debt service is financed by the General Fund, debt service (principle and interest) payments are financed with dedicated restricted revenues. For example, transportation-related debt is financed by state fuel and vehicle registration taxes. Second, the issuance of non-general obligation debt does not require the approval of the Michigan electorate. The Section 15 requirement for voter approval has been interpreted by the courts to apply only to general obligation debt. A total of $19.7 billion in non-general obligation debt was outstanding as of September 30, 2009. Voter-approved debt represented just eight percent of the total long-term outstanding state debt at the end of FY2009. A constitutional convention might consider whether or not voter approval should be a prerequisite for all state debt, regardless of the method of repayment or type of pledge.

Arguments in favor of requiring all state debt to be approved by the electorate contend that it serves as a safeguard against the state becoming over-leveraged and protects against defaults. It is argued that citizens, regardless of the nature of the borrowing, ultimately finance the debts of the state in the form of higher taxes or special charges and therefore they should have a voice in approving that debt.

Opponents of requiring voter approval of all state debt contend that long-term borrowing is a critical financial tool of the state and widely used to support various transportation, housing, and infrastructure projects. Because of the complex and extensive use of long-term borrowing, requiring voter approval will hamstring state officials and delay public service delivery. Arguments against voter approval also center on the fact that revenue-dedicated debt is authorized by the state legislature, which safeguards the public interest.

Short-Term Borrowing

In addition to the long-term general obligation borrowing authorized by Sections 15 and 16, Section 14 allows the state to issue short-term debt (less than one year) backed by the full faith and credit of the state, commonly referred to as "cash flow borrowing." This type of borrowing is used to help manage the cash needs that result from timing differences between receipts and outlays. Section 14 limits cash flow borrowing to "15 percent of undedicated revenues received by the state during the preceding fiscal year" and requires repayment by the end of the fiscal year.

Since FY2003, Michigan has relied heavily on this type of borrowing to manage the daily cash needs of its major funds, the General Fund and School Aid Fund. Short-term notes are generally issued very early in the fiscal year and retired near the end of the fiscal year. For several years prior to FY2003, the state was able to avoid external short-term borrowing, and the associated costs, because the combined General and School Aid Fund cash balance was positive throughout the year. However, the state's on-going structural budget deficits resulted in the deterioration of these positive balances, effectively requiring the major funds to borrowing internally from other state funds and issue short-term notes to meet cash obligations. A constitutional convention would likely examine the state's recent use of this type of borrowing in light of the persistent budget problems and evaluate whether or not the cap should be maintained, decreased, or increased.

Loans to School Districts

Article 16 provides that the state may borrow for the purpose of making loans to school districts, a provision that is statutorily implemented as the school bond loan fund (SBLF). Provision for this program was first introduced to the Michigan Constitution by amendment in 1955, and further amended in 1960. The 1963 Constitution continued the provisions in effect with minor modification.

The SBLF lets school districts borrow from the state the difference between what their debt levy generates and the amount actually needed to make their annual bond payments. In essence, the SBLF allows school districts to borrow under the state's credit rating. In practical terms, the SBLF caps the maximum millage rate that can be levied and extends the repayment over a longer period of time. When adopted, the idea was to allow growing school districts to bond for more than their existing tax bases could support with the expectation that over time their tax bases would grow and eventually the bonds and the state loans would be repaid. It makes

it easier for school districts to convince voters to approve bond sales because it reduces millage levies in the near term in exchange for paying the loans over a longer period, thus pushing part of the cost on to future taxpayers.

A constitutional convention may wish to address several issues related to the SBLF. First, the very structure of the program has been criticized as contributing to urban sprawl. While the program could be justified in the 1950s, as school districts struggled to provide space to "baby boomers," population growth in the state has reached a plateau. Today most of the districts forecasting growth in student populations are on the urban fringes. While the full cost of repaying the bonds needed to build new schools may serve as a deterrent to urban sprawl, the SBLF lowers that cost in the near term.

Although the SBLF is structured to help growing districts, it is not statutorily implemented to serve only such districts. Today, the primary constituency is school districts with relatively low property wealth. Some of these districts are effectively enabled to "game" the system by perpetually borrowing. Once sufficient borrowing has occurred to get a district to the maximum required millage rate, the further incurrence of debt comes at no additional cost to existing taxpayers. Instead, it simply prolongs the repayment periods. After authorizing the sale of $1.5 billion of bonds in 1994, voters in the Detroit Public Schools approved the issuance of $500.5 million of bonds in 2009. The 2009 bond authorization comes at no additional expense to existing taxpayers, but will prolong the period of time that will be needed to retire this debt.

Even if the focus of the SBLF has shifted to helping the state's poorer districts, some of these districts have been unable to participate. Because the tax bases of some districts are sufficiently low, it is not foreseeable that state loans could ever be repaid given a realistic outlook for growth in the district's tax base. Thus, some relatively poor districts like Hamtramck have been turned away, while wealthier districts have benefited from the program.

Local Government Finance

Throughout Michigan's history, local governments have developed a relatively heavy reliance on the property tax as a source of local revenues. As the only source of local revenue available to local governments throughout most of this history, overlapping layers of government were often left to compete with one another for tax resources in the form of escalating property tax rates. For property taxpayers, the result was a growing property tax burden, weighted heavily by levies for school operating purposes.

Responses to the increasingly heavy property tax burden came on several fronts. First, a series of amendments to the state Constitution embedded details of the tax's mechanics and tax rate and base limitations in the state's supreme law. A secondary response was the growth of state aid to local governments in Michigan as a means of compensating local governments for taxes collected at the state level that either were formerly collected at the local level or that preempted local collection of that tax. Over the years state aid has grown into the role of supplementing the reduced property revenues resulting from the tax limitations as well as enabling local governments to keep property tax rates lower than they otherwise might have been. A third response was the enactment of legislation to authorize collection of taxes other than property taxes to ease the property tax burden. However, few municipalities have adopted these alternate sources and there has been little significant reduction of the property tax burden by those that have adopted them. Each of these developments is explored below.

Detail and Complexity

Local governments' reliance on property taxes and the long-standing distrust of the government's power to tax has led Michigan to engrain a great deal of detail into the Constitution. The provisions specifying the mechanics of property taxation contained in the Michigan Constitution are far more detailed than provisions for many other

issues. Sections 3, 4, 5, 6, and 31 of Article IX relate to varied aspects of property taxation.

The inclusion of finite detail in the state Constitution results in a great deal of complexity in the actual administration of the property tax. Administration of the property tax, which tends to be complex by its very nature, is made more complex as the governments and taxpayers wrangle over the meaning of constitutional terms, their application to specific situations, and the ability of the language to be adapted to changing times. This already complex system has been further complicated by layering tax limitations on top of existing provisions. A constitutional convention may want to begin with a goal of eliminating some of the complexity of the property tax system.

Local Tax Limitations

The property tax is among the least popular of the major taxes because: 1) it is paid in one or two lump-sum payments each year; 2) the base of the tax is often the primary possession of residents and businesses (i.e., individuals' homes and the buildings in which the businesses are located) and 3) it is not linked to income and taxpayers need to pay even when their income declines or ceases all together.

Dissatisfaction with the burden placed on taxpayers by the property tax has led to the creation of several limitations in Article IX. Taxes can be limited by controlling growth of the tax base or the tax rate applied to the base. Michigan voters have adopted both methods of limiting property taxes.

Tax Rate

The first limit to property taxes came in 1932 when the 1908 Michigan Constitution was amended to create a 15 mill aggregate limit on all jurisdictions levying property taxes. When the 1963 Constitution was adopted, the 15 mill limitation was maintained and a new 18 mill limit was introduced to eliminate the need for county tax allocation boards. A separate provision was added allowing voters to increase the limitations up to 50 mills for up to 20 years (Section 6).

The principal shortcoming of these tax limitations is that so much millage is excluded that the limitations have been rendered virtually meaningless. Debt service millage levied by local governments is excluded from the 15, 18 and 50 mill limitations, as is operating millage imposed by any city, village, charter county, charter township, charter authority or other authority, the tax limitations of which are provided by charter or by general law. These exclusions explain why aggregate property taxes levied on some parcels of property exceed fifty mills.

Actions to remedy the shortcomings of the tax limitations of the original 1963 Constitution were taken in 1978 as part of the Headlee Amendment. First, the Headlee Amendment created a requirement for local governments to obtain voter approval for the levy of new taxes or for increasing the rate of an existing tax above that which was authorized at the time of the amendment (Section 31). Additionally, a property tax rate rollback provision was established. If the state equalized value of existing property (exclusive of new construction and improvements) in a taxing unit increases more rapidly than inflation, the maximum authorized property tax rate for the taxing unit is reduced so that the total tax levy on existing property is no greater than the prior year levy adjusted for the growth in inflation. This limitation is applied to each taxing unit as a whole, rather than to individual parcels of property within the taxing unit.

The principal shortcoming of these provisions was the application of the limitation to each taxing unit as a whole rather than to individual parcels of property. While the total tax levy of the taxing unit could not increase faster than the rate of inflation without a tax rate override vote, the value of individual parcels could, and often did, appreciate at rates faster than the rate of inflation. It was not unusual to find that the tax burden reduction caused by the tax rate rollbacks, which were calculated based on a unit-wide tax base, were not sufficient to offset the growth in tax burden property owners assumed because of appreciation of their properties.

Property Tax Base

After repeated attempts to limit property taxation by controlling tax rates, Proposal A of 1994 amended Section 3 to introduce a limitation on growth of the tax base. School operating taxes were excluded from the uniformity requirement and taxable value was created as a new measure of tax base. The calculation of taxable value limits annual increases in the value of individual parcels of property to the lesser of five percent or inflation. Property is reassessed at the proper percentage (50 percent) of true cash value when ownership transfers.

Introduction of taxable value as the new tax base created a system in which neighboring properties that are alike in every way but the year of acquisition, can be taxed at starkly different amounts depending on when ownership was last transferred.

Overlapping Limitations

A constitutional convention likely would be asked to address Michigan's overlapping property tax limitations. Each introduction of new property tax limitations has been made without eliminating or amending the existing property tax limitations already in the Constitution, thereby creating a high level of complexity and detail.

Neither the 1978 tax limitations nor the 1994 amendments altered the 15/18/50 mill limitations. Proposal A of 1994 excluded school operating taxes from the 15/18 mill tax limitations, but did not amend those limitations to reflect the change. Because the excluded school operating millages were levied at different tax rates, the limitations that now apply to unchartered counties and unchartered townships vary, which creates confusion at sufficient levels as to become unenforceable.

Proposal A of 1994 also 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 the "pop ups" in value that occur when ownership is transferred. The resulting statutory implementation of these limitations has had a compounding effect creating greater aggregate limitation than either Headlee or Proposal A was designed to achieve individually.

Convention delegates would likely be asked to simplify the property tax limitations into a single enforceable system, although such a task is better suited to the crafting of statute than that of drafting a constitution.

Taxable Value

A constitutional convention might turn its attention specifically to the use of taxable value as the applicable measure of the property tax base. Challenges to modified value acquisition systems of valuing property (such as taxable value in Michigan) because they violate principles of uniform taxation have been upheld on the grounds that states have a rational interest in neighborhood preservation, continuity, and stability.[1] Constitutional convention delegates might ask whether those are in fact policy issues that need to be addressed through Michigan's tax code. Does the need to pursue those goals outweigh the longstanding policy of uniform taxation?

If so, convention delegates might further ask whether a taxable value system of valuing property should be applied to all classes of property, or solely to residential property? The consequences of applying taxable value to non-residential properties are: 1) revenue loss for the state and local governments; and 2) the provision of tax advantages to businesses that have owned the land and buildings longer than other competing businesses. Ownership of residential properties tend to transfer much more frequently than that of commercial and industrial properties, and ownership in each of those classes transfer more frequently than that of agricultural properties. It could be argued that the use of taxable value as the tax base for non-residential properties is detrimental both to governmental finance and to economic development.

State Aid

A secondary response to local governments reliance on property taxes as the primary source of local government revenues has been the development of an extensive system of state aid to local governments.

The state provides a broad range of financial support to its local units of government—cities, vil-

[1] *Nordlinger v. Hahn*, (505 U.S. 1) 1992.

lages, townships, counties, school districts, and community colleges. Three-fifths of all state-levied taxes, fees and other charges are paid to local units of government. The majority of this is required by Sections 8, 10, and 11 of Article IX in payments to school districts, cities, villages, and townships.

Advocates of such a system argue that the collection and distribution of state revenues to local governments lessens the reliance on the property tax and diversifies the finances of local governments. It creates greater equity and efficiency in the financial system by distributing funds in manners different than the origins of the tax collections. It has allowed local governments to keep property tax rates lower than otherwise might have been the case. Furthermore, collection of certain taxes (i.e., sales taxes) by the state is more efficient than would be the case if each local government collected taxes independently.

Alternatively, critics might suggest that state aid has perpetuated an inefficient provision of local government services. The subsidy of local governments allows them to operate independently rather than seeking economies and efficiencies through consolidation and joint service provision. It was after the state began cutting statutory state revenue sharing that local governments intensified their efforts to seek efficiencies in the provision of services through tools such as intergovernmental collaboration. When the state was unable to maintain school aid, the dialog related to school district consolidation intensified.

A constitutional convention might begin an examination of intergovernmental finances by asking whether the requirements that the state provide aid to its local governments should continue to be engrained in the constitution. The complete elimination of these provisions would free the state legislature to focus on state services (including aid to local governments through a statutory system of sharing state revenues if the legislature so chooses). Alternatively, state aid could be replaced with a system of regional funding structures that would allow different regions of the state to focus on their own particular needs.

Depending on how a constitutional convention deals with the state aid provisions, it may also look at the safeguards that were inserted into the Constitution to protect against erosion of state aid. Separate amendments have attempted to prevent diminution of state aid and transfers of responsibility for service delivery without adequate state funding to meet those increased local costs.

Sections 29 and 30 of the Headlee Amendment were thought to be necessary because a companion section, Section 26, limits state government revenues in any given year to a fixed percentage of total personal income. Drafters of the Headlee Amendment anticipated that state policymakers might attempt to mitigate the effects of the revenue limit by shifting to units of local government responsibility for programs previously funded by the state.

State Aid to Local Governments

Section 30, added to Article IX by the 1978 Headlee Amendment, requires the state to maintain the level of state spending paid to local governments at a level at least equal to what was paid in 1978. Since adoption of Proposal A in 1994, when the state assumed primary responsibility for funding school operations, state spending to local governments has been well in excess of the Section 30 funding requirement. A constitutional convention might consider whether such a requirement should be continued in a revised constitution, and if so, at what level.

Mandates on Local Governments

Section 29 requires the state to pay in subsequent years at least the same proportion of costs for activities or services required of units of local government as it paid in 1978, the year in which the amendment took effect.

The history of Section 29 suggests that, if it is desirable to extend such a provision into a new constitution, changes will be needed to make it work better. First, notwithstanding a few lawsuits that have been filed to challenge funding changes by the state, the provisions of Section 29 have been wholly disregarded. A process for identifying mandates and providing disbursements to fund state requirements for local governments was never implemented. The system created to identify existing mandates fell apart. Mandates were enacted without sufficient funding.

Additionally, it will be necessary to provide greater definition to the types of legislative directives

that would warrant the accompaniment of state funding. State and local officials have tended to define the concept of "activities and services required of units of Local Government by state law" differently. While the local government officials tend to look upon such requirements as any law or regulation that causes activities and services to be provided in a specific way, state officials, and the courts, have used a much narrower definition that defines mandates to include only those laws and regulations that apply to all local governments of a type (i.e., all school districts, all counties, etc.).

Examination of the constitutions and laws of other states reveals 28 states with constitutional or statutory requirements that state funding accompany any state laws that mandate local government services and activities.[2] A constitutional convention may address mandates in one of three ways: 1) examine the provisions of other states with similar limitations for best practices with the goal of strengthening the restrictions on unfunded mandates; 2) join the 22 states without such requirements for state funding of local government mandates; or 3) keep the current provision in place but amend it so it serves as a meaningful restriction.

[2] See CRC Report 355, *Reforming the Process for Identifying and Funding Section 29 Mandates on Local Governments*, July 2009.

Alternative Tax Sources

The decline in state shared revenues coupled with a contraction of the property tax base because of departures of people and businesses from Michigan and the nationwide bursting of the housing bubble has heightened the desire among local government officials for alternative funding sources to supplement or replace the property tax.

As was detailed in CRC's analysis of Article VII[3], one way in which the state has weakened the constitutional grant of home rule powers to local governments was by limiting their ability to levy local taxes. Article VII, Section 21 provides that "Each city and village is granted power to levy other taxes for public purposes, subject to limitations and prohibitions provided by this constitution or by law." Unlike many other states with strong home rule provisions that do not limit their local governments in this way, Michigan laws require an authorizing state law for local governments to levy alternate taxes.

Cities have local option income taxes at their disposal, but neither counties, villages, townships, nor school districts currently can use this or other funding sources. Independent of the article on local government, a constitutional convention might opt to include authorization for alternative funding sources for local governments in the article on finance and taxation. In doing so, a constitutional convention might consider whether the current provisions related to the sales tax collude to prohibit local governments from levying sales taxes.

Local Sales Tax Prohibition

Local government officials and proponents of regional service provision have investigated the possibility of local-option sales taxes in Michigan. The sales tax rate limitation in Section 8 appears to not permit local sales taxes. The primary impediment arises from a conclusion that the local taxes would be subject to the aggregate rate limitation provided in the section. The current constitutional language is unclear whether the rate limitation was intended to apply only to a state sales tax or also to a local sales tax. According to a 1970 state Attorney General opinion, the legislature can only authorize a local sales tax by amending the state Constitution, since the voters who ratified the Constitution intended to designate the sales tax "as a state sales tax."[4] Furthermore, even if the state were to yield part of its current taxing authority to local governments, revenues collected from local

[3] See CRC Report 360-10, *Article VII – Local Government*, June 2010.

[4] OAG, 1969-1970, No. 4694.

sales taxes would be subject to the same dedication requirements found in sections 8, 10, and 11 (discussed earlier).[5]

It is worth noting that the wording of Section 8 stands in contrast to that of Section 7 which prohibits "the state or any of its subdivisions" from imposing a graduated income tax. These two sections, when read together, suggest that when the drafters of the 1963 Constitution intended to limit not only state legislative authority, but also the authority of units of local government, they clearly expressed that intent.

Although the issue has been addressed by the Attorney General (which has the effect of law until modified by the courts), the courts have not determined the legality of local sales taxes. Given the tight statutory and constitutional constraints on local government revenue-raising options, and in light of the growing fiscal challenges facing local governments prospectively, a constitutional convention is likely to consider the questions surrounding the legality of local-option sales taxes.

[5] See CRC Report No. 305, *Issues Relating to the Constitutionality of Local Sales Taxation in Michigan,* June, 1992.

Other Headlee Amendment Issues

Beyond the state and local government tax and revenue limitations established by the Headlee Amendment that are discussed above, a constitutional convention may direct its attention to other constitutional issues created by that amendment. For instance, Section 25 serves as a preamble to sections 26 through 34, the purposes of which are apparent upon reading the sections. Section 33 provides definition for several of the significant terms fundamental to the Headlee Amendment's limitations. This practice is commonly left to the legislature in other parts of the Constitution, as can be seen by the number of times the drafters used the term "as defined by law." Section 34 directs the legislature to statutorily implement sections 25 through 33, a role that defaults to the legislature in any case because the Michigan Constitution is not self executing. These sections serve no other purposes. Convention delegates may wish to begin their task by cleaning these sections out of the Constitution.

Definition of a "Tax"

Section 31 provides that "Units of Local Government are hereby prohibited from levying any *tax* not authorized by law or charter when this section is ratified or from increasing the rate of an existing *tax* above the rate authorized by law or charter when this section is ratified…" Although Section 33 defines a number of other terms contained in the Headlee Amendment, it does not define the term "tax." As a result, the courts have played a very important role in differentiating taxes from fees and from special assessments, especially ad valorem special assessments. If a constitutional convention opts to continue the tax limitations created by the Headlee Amendment, it could serve a vital role in providing greater definition and clarifying the extent to which local governments can use these funding tools to, at times, circumvent the intent of the limitation.

Role of the Court of Appeals

Section 32 provides that "Any taxpayer of the state shall have standing to bring suit in the Michigan Court of Appeals to enforce provisions of Sections 25 through 31…" The drafters' notes do not indicate why the authors of the Headlee Amendment chose the Court of Appeals as the forum in which taxpayers could bring original enforcement actions. Therefore, it cannot be determined whether the drafters anticipated the difficulty that that choice would produce. Presumably, the drafters hoped to expedite the process of challenging government actions by eliminating one level of court hearings, the circuit courts that usually have full dockets, and one set of appeals.

The Court of Appeals has been reluctant to play the role that the Headlee Amendment created for it. In the most notable case, a lawsuit was filed in 1980 in the Michigan Court of Appeals on behalf of seven taxpayers, including Donald Durant, a resident of

the Fitzgerald School District.[6] The essence of the lawsuit was that state officials had reduced the proportion of educational costs paid by the state to a level below that required by the Headlee Amendment. Over the next 17 years, the *Durant* case would beat a well-worn path between the Court of Appeals and the Supreme Court, often due to the Court of Appeals recalcitrance in carrying out its assigned role. The Court of Appeals essentially refused to consider *Durant* on its merits, choosing instead on two separate occasions to dismiss the case on technical grounds. While it is true that the case raised a number of complex factual issues, the court was not without options for dealing with them.

The court's recalcitrance stems from the fact that the Court of Appeals is an appellate court. It was not established to handle complicated factual issues, which are often at the heart of taxpayer lawsuits, but to resolve issues of law raised on appeal from trial courts. Given the purpose that the Court of Appeals serves, the decision to assign to it responsibility to hear taxpayer lawsuits was arguably ill advised.

Should provisions of the Headlee Amendment be carried forward to a new document, a constitutional convention would likely be called upon to decide whether a unique legal process is needed for enforcing the relevant provisions.

[6] *Durant v. State of Michigan*, 456 Michigan 175, 566 NW2d 272 (1997).

Public Pension and Other Post-Employment Benefits

Both state and local public pension plans and retirement systems in Michigan enjoy considerable constitutional protections under Section 24. Specifically, this section establishes the "accrued financial benefits" of each plan or system as a contractual obligation of the unit of government responsible for administering the benefit program. Furthermore, the section prohibits the benefits from being "diminished or impaired" by the governmental unit. Section 24 also contains a provision relating to how the financial benefits shall be funded by each unit of government and prohibits the funding for current services from being used to finance "unfunded accrued liabilities", or the amount that the accrued actuarially-determined liabilities of a pension fund exceed the fund's assets.

Two public policy issues arise in Section 24 that a convention might consider. First, a convention might consider whether the state's constitution should contain an explicit protection for public pension benefits or if such protection should be left to statutory law and decisions of the courts. Second, the term "accrued financial obligations" has been interpreted by the Michigan Supreme Court to be limited to pension benefits, but not other post-employment benefits (OPEBs), i.e., primarily health care benefits. The disparate treatment of pension benefits versus OPEBs would likely garner some attention during a convention.

The constitutional protections of public pensions from being "diminished or impaired" are understood to prevent state government, or its subdivisions, from reneging on benefits previously earned based on services rendered. This does not prevent a unit of government, the employer, from modifying the level of future benefits offered to its employees prospectively. Also, this safeguard is understood to shield public pension and retirement income from taxation by state and local governments. Private pension and retirement benefits do not enjoy the same constitutional protection from taxation, although state law does provide some degree of protection to private pension benefits.[7] Currently, the Michigan Legislature could provide for full taxation of private pension and retirement income; however, such actions would likely raise equity concerns over the different treatment of public and private plans.

Although the majority of states provide some form of constitutional protection for their pensions, Michigan is somewhat unique in that it is one of only nine states where participants in the public pension plans have a guaranteed

[7] The Income Tax Act of 1967 (Public Act 281 of 1967) provides a deduction from "taxable income" for a portion of private pension and retirement benefits received.

right to a benefit and that accrued financial benefits cannot be diminished or eliminated, pursuant to constitutional law. In all other states, legal protections are provided through state laws or the courts have ruled that there are safeguards based on due process or federal constitutional provisions that protect contracts.[8] In addition to the protection from impairment, Section 24 requires full actuarial funding each fiscal year for services rendered that year and prohibits the funding from being used to satisfy unfunded actuarial accrued liabilities (UAAL). This does not prohibit financing the UAAL associated with a pension plan, only that funding intended to satisfy the "normal" cost of plan can not be diverted to the UAAL.

[8] The other eight states are: Alaska, Arizona, Hawaii, Illinois, Louisiana, Missouri, New Mexico, New York. *State and Local Government Retiree Benefits, Report to Committee on Finance, U.S. Senate,* U.S. Government Accountability Office, 2007.

While public pensions enjoy considerable legal protections from infringement by the government, OPEBs do not according to opinions rendered by the Michigan Supreme Court. In *Studier v. Michigan Public Employees' Retirement System*, 472 Mich 642; NW2d 350 (2005), it was determined that health care benefits do not constitute "accrued financial benefits" as the term is used in Section 24. In effect, the Supreme Court ruled that health care benefits are not protected by the Constitution from diminishment or impairment in the way that pension benefits are protected.

Options to diminish or impair OPEBs do not relate to the taxation of such benefits, like the pension benefit, but to changes in the cost-sharing arrangements between employers and employees/retirees. As the costs of post-retirement benefits continue to rise (both at the aggregate and at the per-retiree level), and state and local governments face growing fiscal challenges, it is likely that employers will be pressured to shift more of the costs of previously-promised benefits to retirees or current employees. This can occur by requiring retirees or employees to pick up larger shares of the benefit costs, either in retirement or during their active working years.[9] A constitutional convention would be expected to review, and possibly clarify, the degree to which the Michigan Constitution should protect certain OPEBs from being diminished or impaired.

[9] For example, recent statutory changes to the state-administered retirement program covering public school employees (Public Act 75 of 2010) requires current school employees to contribute three percent of their salary to cover retiree health care costs. The required charge is intended to partially offset the employer's costs associated with provided the benefit. It should be noted that a constitutional challenge to PA 75 was initiated by a group of school employees, citing the protections provided under Article IX, Section 24 to health care benefits and arguing that the new, mandatory employee contribution constitutes an impairment of the benefits.

Constitutional Sections of Statutory Nature

A constitutional purist might begin by asking how much of the current Article IX belongs in a constitution and how much should be left to legislative discretion and contained in state law. This line of thinking suggests that a constitution should not be an elaborate document. It should be relatively compact and economical in its general arrangement and draftsmanship. Details, including those provisions related to finance and taxation, should be avoided and matters appropriate for legislation should not be incorporated into the organic document. As was detailed above, much of Article IX either limits the ability to tax or dedicates revenues to specific purposes.

The most obvious example of purely statutory language in the Constitution is found in Sections 35 and 35a and 37-42 of Article IX, placed in the Constitution in a series of five amendments, totaling some 3,118 words (or about nine percent of the Constitution), from 1984 to 2006. These amendments lifted language directly from existing statutes and placed it in the Constitution to prevent the legislature from using balances in various funds for purposes other than those for which those balances were created.

Conclusion

The role of a state constitution in serving as a limitation on the governmental power of the state is exercised most overtly in matters of tax and finance. Drafters of the 1963 Constitution provided the legislature with a "power of the purse" that is bound by constitutional limitations on the type of taxes that may be employed and the rates of certain taxes that may be levied. Subsequent amendments to the Constitution added further limitations to this foundational legislative power. As a result, should a constitutional convention be called at the November, 2010 election, the delegates may feel as though a good deal of their time is served in a legislative role dealing with provisions of Article IX that are very statutory in nature and determining the level of discretion that should be afforded to state lawmakers in terms of fiscal matters.