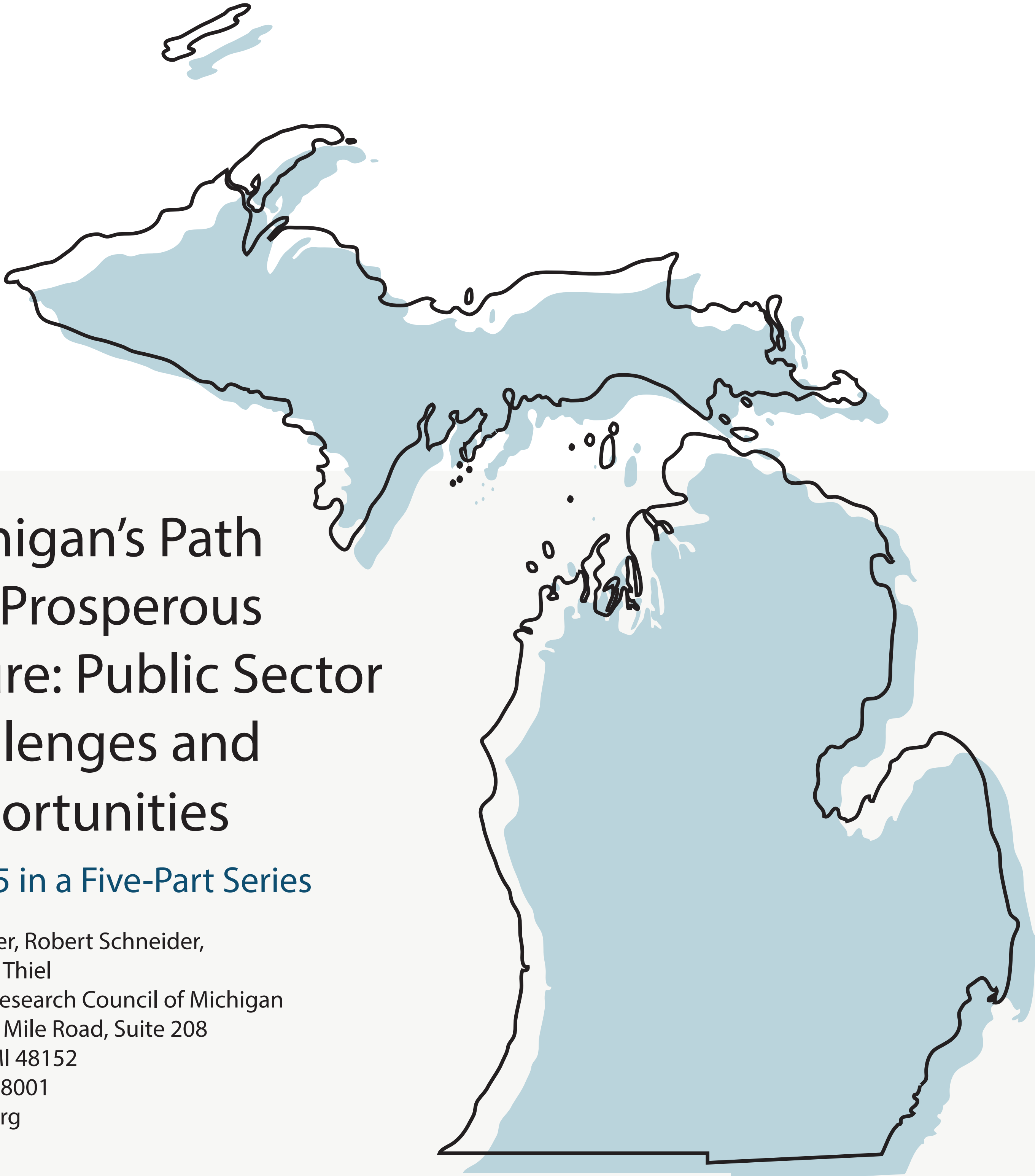

Michigan's Path to a Prosperous Future: Public Sector Challenges and Opportunities

Paper 5 in a Five-Part Series

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CITIZENS RESEARCH COUNCIL OF MICHIGAN

About the Series

Altarum and the Citizens Research Council of Michigan have joined forces to present a realistic, data-informed vision of Michigan's future based on current trends and trajectories across multiple dimensions – economic, demographic, workforce, infrastructure, environment, and public services. The papers are available on both organizations' websites.

Research for this project was conducted in two phases. Phase I involved a landscape scan of existing resources and expert knowledge of trends and challenges. For each domain, published and grey literature were reviewed and interviews with stakeholders were conducted to answer questions such as:

- Where is Michigan now – strengths, weaknesses, major challenges?
- What data is available to characterize the current situation and to track progress? Are there existing forecasts, either descriptive or data-driven?
- How does Michigan compare to other states, especially in the Midwest?
- What path are we on currently, and where are opportunities to shift the path through policies and investment?

Phase 2, as represented in an Executive Summary and a series of five papers, built on Phase 1 to include data and context.

Altarum (altarum.org) is a nonprofit organization focused on improving the health of individuals with fewer financial resources and populations disenfranchised by the health care system.

The Citizens Research Council (crcmich.org) works to improve government in Michigan by providing factual, unbiased, independent information concerning significant issues of state and local government organization, policy, and finance.

The project was funded by the Charles Stewart Mott Foundation, The Kresge Foundation, Ralph C. Wilson, Jr. Foundation, Hudson-Webber Foundation, Grand Rapids Community Foundation, W.K. Kellogg Foundation, Max M. and Marjorie S. Fisher Foundation, Michigan Health Endowment Fund, The Joyce Foundation, The Skillman Foundation, and the Ballmer Group.

Report Highlights

State Government

- Efforts to be competitive on taxes have caused Michigan's state and local governments to make difficult decisions, often reducing funding for key services. They are smaller and less capable of providing services than they were 20 years ago.
- Under current projections, inflation-adjusted General Fund/General Purpose revenue will remain 25 percent below its FY2000 level in FY2025.
- In FY2001, state revenue supported 69.8 percent of the total state budget. By FY2024, that percentage fell to 58.5 percent.
- While total appropriations to state universities and community colleges have increased over time, inflation-adjusted funding in the FY2024 state budget is down by 25.6 percent from the FY2001 level.
- On an inflation-adjusted basis, funding for state revenue sharing to local governments remains 35 percent below its FY2001 peak.
- Appropriations for health and human services have nearly tripled between FY2001 and FY2024 and have grown by 76.1 percent even after adjusting for inflation. However, spending within this budget has moved in different directions. The federally-administered Supplemental Nutrition Assistance Program and Medicaid spending have increased significantly while funding for the Family Independence Program and Child Development and Care Program has declined.
- Taken together, the combined Budget Stabilization Fund and School Aid Stabilization Fund balances give the state just over $2.4 billion in revenue reserves – just shy of 7.9 percent of combined GF/GP and SAF revenue.
- State generated tax revenue in FY2022 was equivalent to 7.1 percent of all Michigan personal income. In FY1991 that percentage was 6.5 percent. However, it is important to note that state tax revenues are used to fund more services today than they were 30 years ago.

Local Government

- Michigan local governments are more constrained in their tax options than those in many other states.
- Michigan's property tax limitations create incentives to develop land, thus encouraging urban sprawl, and to increase tax rates.
- State revenue sharing was modeled to provide some diversification in the revenue structure of local governments in place of local-option taxes. The chronic underfunding of this program over the past 20 years has left local governments without the funding or options to raise revenues on their own.
- Advances in communication, technology, and transportation make small local governments an inefficient way to provide services. Furthermore, Michigan's local government model deters communities from adopting a regional focus and policies that benefit the region, which is necessary to create vibrant economies and regions that will attract and retain residents.
- Strong vibrant cities are important elements to attract new residents, especially young people, but the ability for Michigan cities to compete is frustrated by the municipal finance model, the inability to use local-option sales taxes, urban areas that reflect years of urban sprawl, the degree residents have self-segregated themselves by income and race, and the lack of regional focus.
- Michigan's low-income communities, which are disproportionately majority-minority communities, are feeling the consequences of Michigan's broken local government model before the wealthier places.

Introduction

This is the fifth of a five-part series presenting a realistic, data-informed vision of Michigan's future based on current trends and trajectories across multiple dimensions – economic, demographic, workforce, infrastructure, environment, and public services. The papers before it laid out a scenario of stagnant population growth driven by an aging population with insufficient natural and international migration into the state to compensate for decreasing natural growth. It established that people of color will constitute ever larger proportions of the state population.

The papers establish that there are bidirectional relationships between the stagnant population growth and the economy, workforce and talent, the health of the state population, the wellbeing of the environment, and the condition of the infrastructure.

They established that Michigan's economy has recovered since the "lost decade" between 2000 and 2010, but still lags the U.S. average on a variety of measures of wealth and prosperity. Michigan now falls in the bottom third of all states for measures such as per capita personal income and median household income. Michigan also ranks behind nine of the ten neighboring Midwest states on these measures.

Michigan's 4th-grade and 8th-grade students scored well below the national average on standardized proficiency tests for reading and math in 2022. Data demonstrates that college degree attainment is a key factor in determining a state's economic prosperity, but Michigan ranked 34th nationally in the percentages of its 25-and-older population that held at least an associate's degree. It also ranked behind most of its Midwest neighbors.

Segments of Michigan's population are disproportionately affected by poverty and low educational attainment; these residents are also more likely to live in areas with low-performing schools. Economic opportunity is not equitably shared across all residents in several important ways, and Michigan is relatively weaker in this regard than the country. Michigan residents experience greater income disparity than the nation across racial, ethnic, and geographic lines. Also, a greater share of Michigan's Black, Native American, and Hispanic/Latino populations live with incomes below the federal poverty level.

The previous reports in the series also establish a relationship between the economic condition of the state and the health of its residents. Health is impacted by more than the availability and affordability of care. Social and economic factors, such as education, poverty, exposure to crime, and food insecurity, are leading to the poor health status of Michiganders. It's no coincidence that as Michigan continues to rank among the worst states based on the economy, education system, and infrastructure, the health of the population continues to decline. Significantly, Michigan ranks 40th among states for per-capita spending on public health, and consistently spends less per capita on public health than the national average.

The reports also establish the severity of Michigan's infrastructure problems. Michigan's infrastructure systems tend to underperform both national averages and nearby peer states. Michiganders suffer some of the nation's poorest road pavement conditions. Many communities struggle to dependably provide residents with clean drinking water. Outdated and under-capacity storm sewers amplify problems of flooding and water pollution, and Michigan power customers pay higher-than-average rates for electric service while receiving below average reliability.

Michigan's unmatched natural resources, particularly the Great Lakes, are significant assets that could be utilized to attract new residents to the state. However, leveraging natural resources for economic growth is complicated by Michigan's industrial legacy. An increased emphasis on environmental protection and remediation is necessary to improve environmental and public health, as well as the perception of the state to outsiders. The air, land, and water in Michigan for most provides clean, safe environments, but many urban neighborhoods near industrial facilities are subject to multiple environmental pollutants, each of which individually remain under thresholds that would require a regulatory response, but the cumulative effect of them can lead to chronic health conditions. Such areas have been referred to as "sacrifice zones," as the health and wellbeing of the residents has been sacrificed for perceived economic benefit.

Not all of these ills fall on state and local governments to solve, but it is notable that the conditions of many of these items worsened during Michigan's "lost decade", when economic hardships and scarce resources constrained the ability of Michigan's state and local governments to maintain staffing levels, funding, regulatory efforts, and commitments to make Michigan a destination for people and businesses.

A healthy, functioning government sector is the common thread in investing in the people, places, and assets to drive the economy forward and to create communities where people want to live. The public goods and services financed by the state and local governments provide opportunities for private sector businesses to succeed.

Efforts to be competitive on taxes have caused Michigan's state and local governments to make difficult decisions, often reducing funding for key services. They are smaller and less capable of providing services than they were 20 years ago. Advocates of smaller government may applaud this result, but these changes have real world consequences in the competition for people and businesses. The following discussion will describe the current conditions of Michigan's state and local governments and assess their capacity to deal with the issues described in the first four papers.

State Government

Michigan's state government is responsible for providing a wide array of important public services for residents. These include public education (from pre-kindergarten through college); safety net programs such as Medicaid and public assistance programs; public protection through the administration of the state's corrections system, and provision of state police services; and addressing public infrastructure needs, most notably Michigan's large system of public roads.

Providing effective public services, however, requires money, and Michigan has navigated a unique path among states over the last 25 years in terms of growth trends in the state revenue needed to support most of these public functions. While the state's current financial picture appears strong, that picture was less positive in the not-too-distant past. During the first decade of the new century, Michigan endured what many refer to as a "single state recession" with persistent declines in employment at a time when the national economy was growing. The start of the Great Recession in 2007 made the situation worse. The sluggish Michigan economy along with state tax policy decisions had a huge negative impact on state revenue, particularly on Michigan's discretionary General Fund/General Purpose revenue which is the focus of much of the state's annual budget deliberations.

In Fiscal Year (FY)2010, as the nation began to climb out of the Great Recession, Michigan's state revenue trajectory also reversed course, and the state has experienced consistent growth in revenues since that time. However, the analysis will outline how Michigan's "lost decade" and the revenue declines that came with it still impact funding for critical state functions.

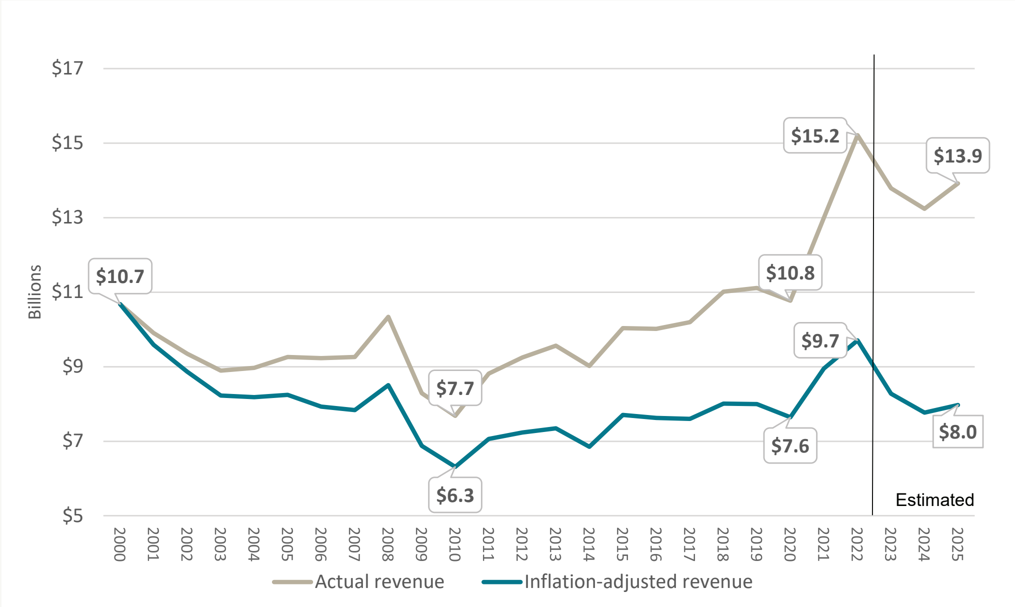
State Revenue Trends Since FY2001

The State of Michigan relies on two major funds to support much of its state-financed public programs: the School Aid Fund (SAF) which supports public K-12 education, public pre-school programs, and a portion of the operating cost of public post-secondary institutions; and discretionary General Fund/General Purpose (GF/GP) revenue which supports much of the remaining state budget.

Between FY2000 and FY2010, GF/GP revenue declined by $3 billion, a 27 percent reduction (Figure 1). Several factors contributed to the significant decline:

- As noted, the state's stagnant economic growth and employment losses during this period reduced personal income, which in turn reduced revenue from state income and sales taxes which are sensitive to economic conditions.
- The state initiated a phase-down of the state personal income tax rate from 4.4 percent to 3.9 percent between 1999 and 2004; the rate was eventually raised back to 4.35 percent in 2007 before falling to its current level of 4.25 percent in 2012.
- The gradual reduction of the state's primary business tax rate between 1999 and 2007 before the tax was replaced that year by a new restructured business tax.

Figure 1: General Fund/General Purpose Revenue History, FY2000 to FY2025 (est.)



Source: Michigan Senate Fiscal Agency and May 2023 Consensus Revenue Estimating Conference Executive Summary.

This revenue decline forced state policymakers to make difficult decisions within the state budget. Large budget reductions were implemented across all of state government and the full-time state workforce declined by more than 23 percent between FY2001 and FY2011. Few areas of the budget were spared from reductions, resulting in the decline in the sufficiency and quality of many state services. However, budget reductions were particularly severe in some major areas that will be discussed in the next section.

While GF/GP revenue growth has been stronger since that trough, it has still not recovered on an inflation-adjusted basis. Further, additional income tax reductions implemented in March 2023 – including a one year income tax rate reduction and changes restoring more favorable treatment of retirement income and an expanded Earned Income Tax Credit – will eat into what had been a COVID-related boost to state tax receipts and GF/GP revenue. Under current projections, FY2025 inflation-adjusted GF/GP revenue will remain 25 percent below its FY2000 level.[1]

While the School Aid Fund also experienced sluggish growth between FY2000 and FY2010, its dedicated tax receipts were largely held harmless from the tax policy changes noted above. As such, revenue remained more stable and School Aid budget cuts during the period were less severe than in other areas of the budget. However, budget pressures did result in some on-going SAF revenue being tapped for use in funding universities and community colleges. Previously, that revenue had been used exclusively for K-12 education purposes.

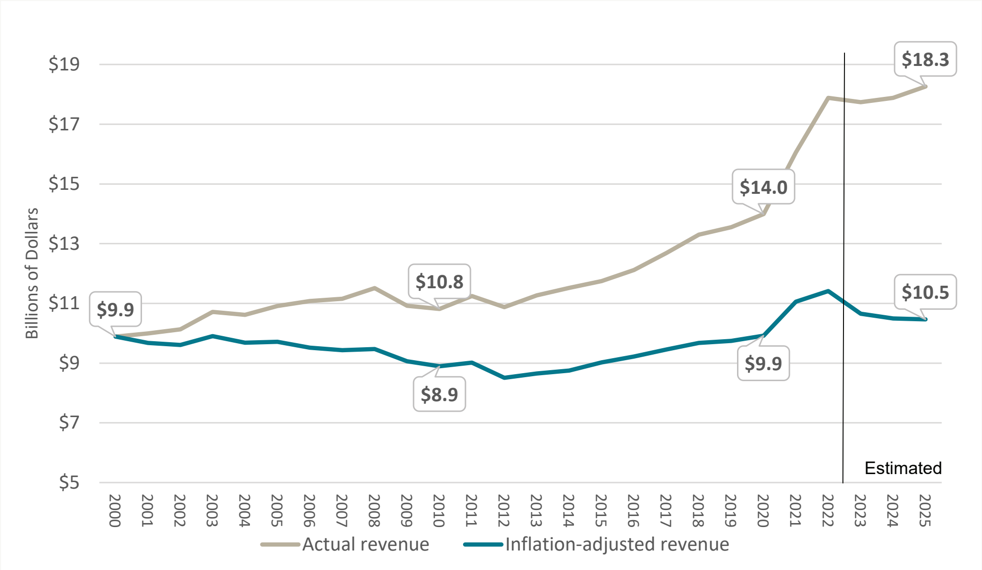
On an inflation-adjusted basis, School Aid revenue declined between FY2000 and FY2012 before growing again for most of the next decade (Figure 2). FY2025 inflation-adjusted revenues are expected to be above their FY2000 levels by almost six percent.

Weakness: Legacies of a "Lost Decade" in the State Budget

The revenue challenges during the first decade of the new century had significant impacts on the state budget, but those impacts were not uniform across all state functions. Since the state's General Fund receipts took the biggest hit between FY2000 and FY2010, departments and programs that relied on GF/GP revenue also were particularly susceptible to budget reductions. Looking at the state budget on an inflation-adjusted basis, total funding from all revenue sources (which include federal, state, local, and private funds) actually grew slowly between 2000 and 2010 and increased fairly significantly in the next decade. In contrast, inflation-adjusted funding from state revenues fell between FY2000 and FY2010 and were still below their FY2000 level in FY2020 before spiking during the COVID-related revenue boom (Figure 3).

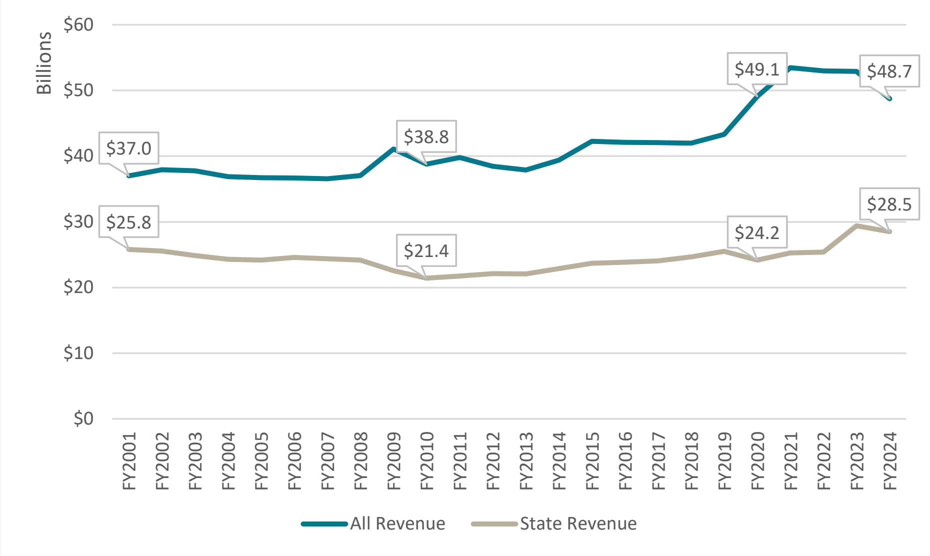
[1] All inflation-adjusted values in this report are based on the Detroit Consumer Price Index for all urban consumers (CPI-U).

Figure 2: School Aid Fund Revenue History, FY2000 to FY2025 (est.)



Source: Michigan Senate Fiscal Agency and May 2023 Consensus Revenue Estimating Conference Executive Summary.

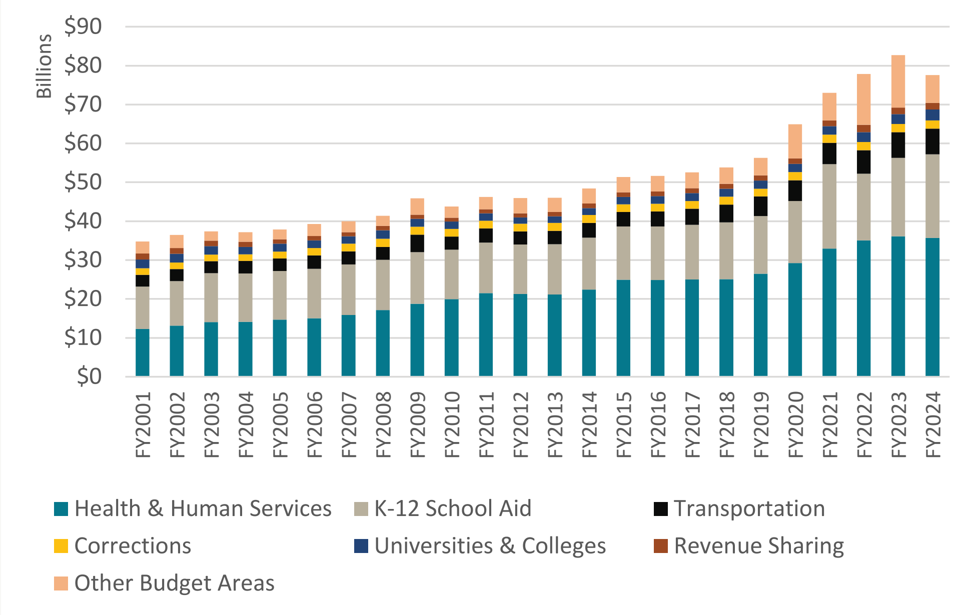
Figure 3: Inflation-Adjusted Appropriations, FY2001 to FY2024 (budgeted)



Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

Nearly all of that non-state revenue supporting the budget comes from the federal government, and that federal revenue grew in prominence over the last 25 years. In FY2001, state revenue supported 69.8 percent of the total state budget. By FY2024, that percentage fell to 58.5 percent. Much of the state budget's growth can be attributed to programs that receive significant amounts of federal support. Figure 4 outlines total funding in the state budget by major department/function. The subsections that follow examine some of the program areas that were hardest hit by the slow revenue growth experienced a decade ago.

Figure 4: State Budget History by Function, FY2001 to FY2024 (budgeted)



Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

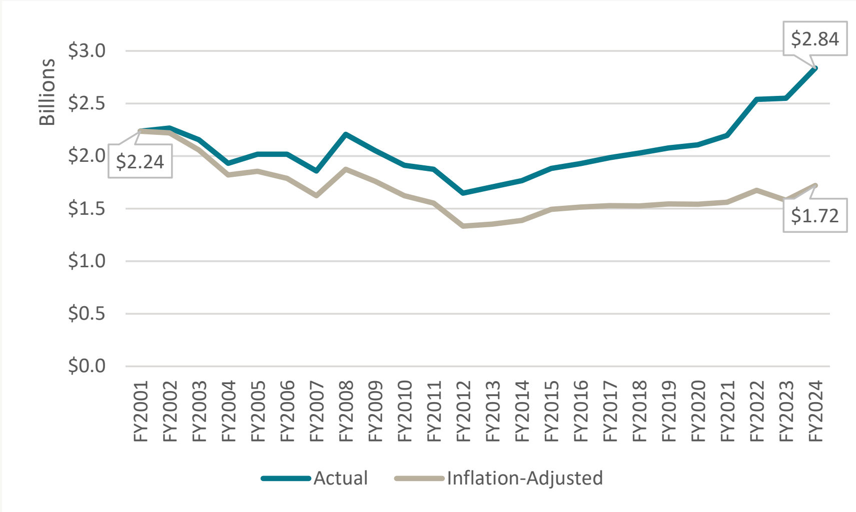
Universities and Community Colleges

As noted in previous reports in this series, Michigan falls below national averages in the percentage of the working age population with a college degree. This represents a major weakness for the state's economic prospects as high-wage employment is increasingly concentrated in occupations that require a two-year or four-year degree. However, operating support to the state's public post-secondary institutions was one of the areas hit hardest by funding cuts during Michigan's budget crisis.

While total appropriations have increased over time, inflation-adjusted funding in the FY2024 state budget is down by 25.6 percent from the FY2001 level (Figure 5).

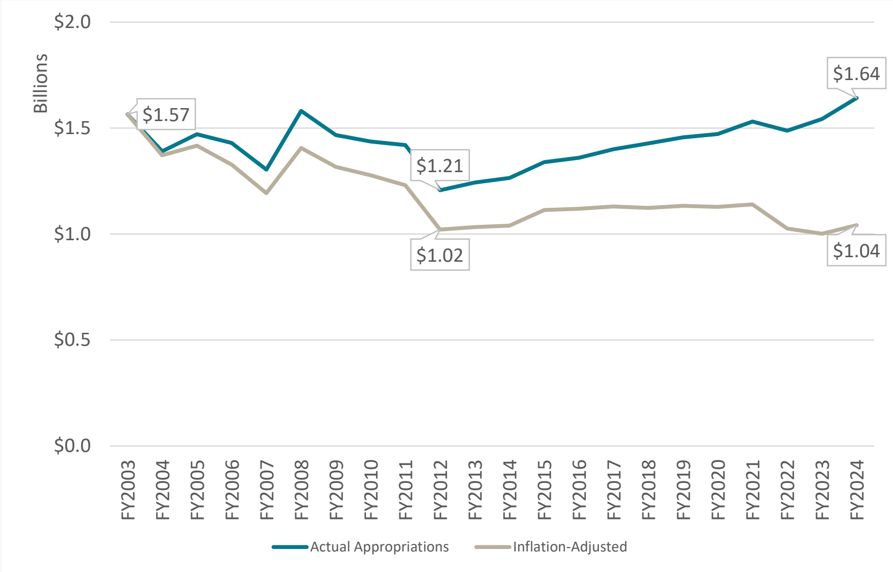
Budget cuts have been particularly pronounced for the state's public universities. Between Fiscal Years 2003 and 2012, operating grants were cut by $358 million, a 23 percent reduction (Figure 6). While funding has been gradually restored in the years since, it remains below its FY2003 peak. Adjusted for inflation, operating support to the state's public universities remains 34 percent below the level from two decades ago.

Figure 5: Funding to Universities and Colleges, FY2001 to FY2024 (budgeted)



Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

Figure 6: Appropriations for Public University Operations, FY2001 to FY2024 (budgeted)



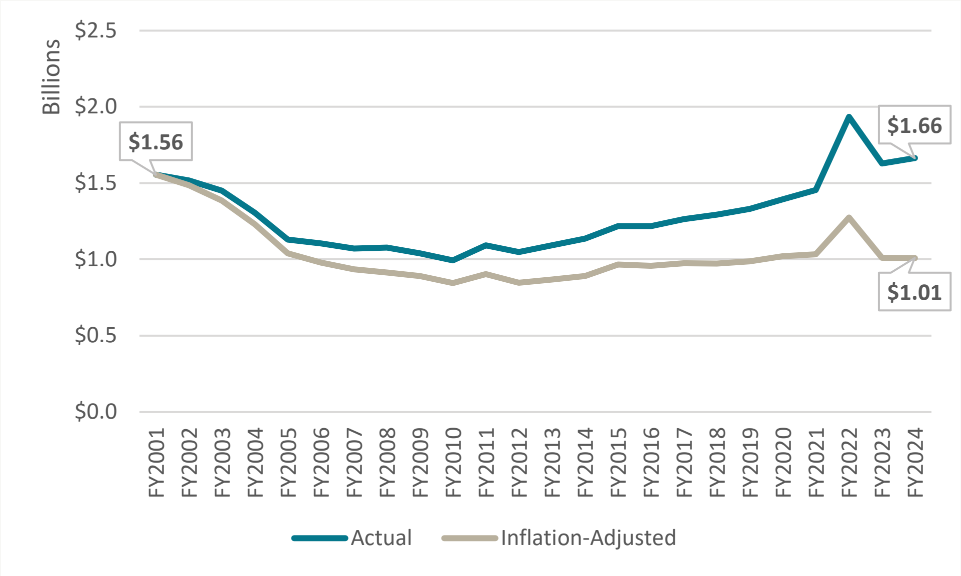
Source: Michigan House Fiscal Agency data.

State Revenue Sharing to Local Governments

Discretionary state revenue sharing payments to local units of government, which are financed with GF/GP revenues, were also reduced significantly during the state's budget challenges, creating financial strain on local governments around the state. Between FY2001 and FY2010, funding was cut by over $560 million, a 36 percent decline (Figure 7). While appropriations have increased since, current funding is only slightly higher now than the level provided two decades ago. On an inflation-adjusted basis, funding remains 35 percent below its FY2001 peak.

The next section of the report on local government discusses this and other challenges to local governments in financing public services.

Figure 7: Revenue Sharing Funding, FY2001 to FY2024 (budgeted)

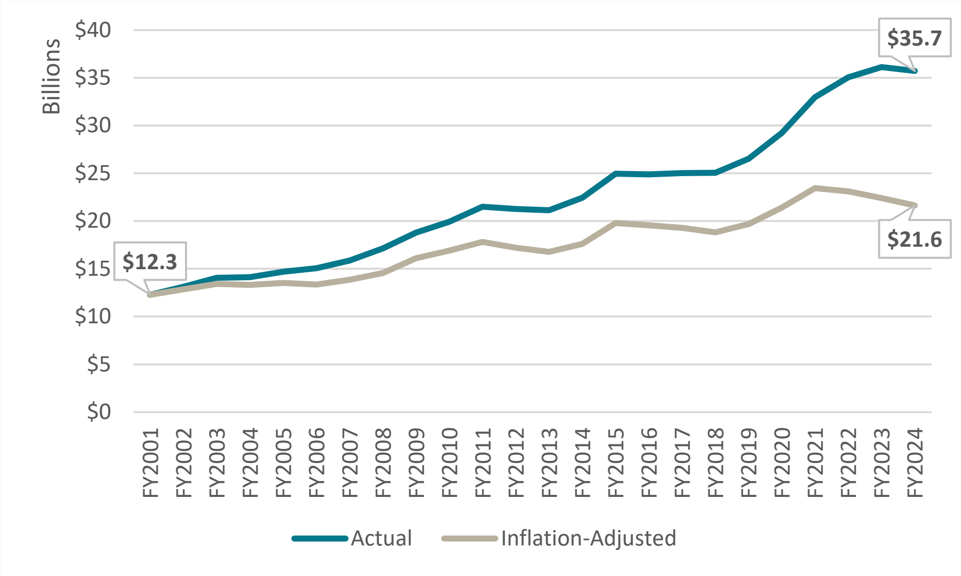


Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

Health and Human Services

One of the largest areas of growth in the overall state budget is funding to the Department of Health and Human Services. Appropriations to the department have nearly tripled between FY2001 and FY2024 and have grown by 76.1 percent even after adjusting for inflation (Figure 8).

Figure 8: Health & Human Services Funding, FY2001 to FY2024 (budgeted)

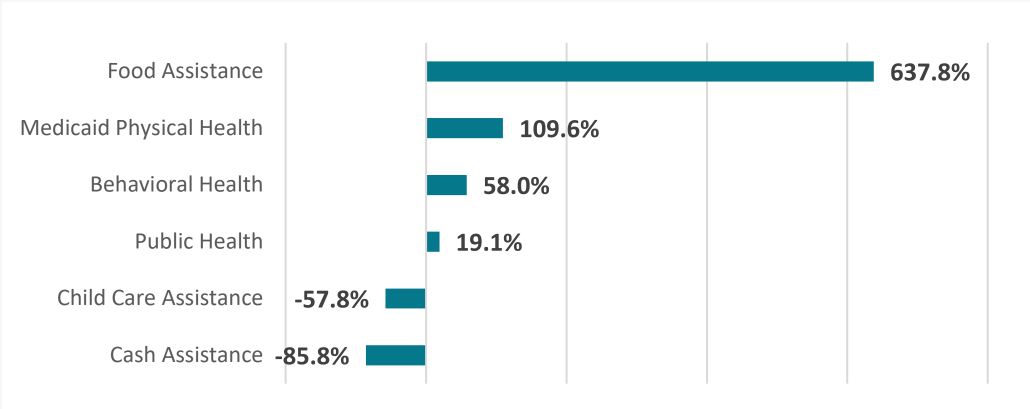


Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

However, growth rates fluctuate significantly across different programs and functions. For instance, food assistance payments through the federally-administered Supplemental Nutrition Assistance Program grew by 638 percent on an inflation-adjusted basis over this period; reflecting a massive growth in eligible cases under the federally-funded program. Similarly, the state's Medicaid program addressing physical healthcare needs of income-eligible households grew by 110 percent, reflecting both healthcare cost inflation and the expansion of Medicaid-eligible residents in Michigan under the Affordable Care Act.

In contrast, many public assistance programs have seen negative inflation-adjusted growth over this period. Michigan's Family Independence Program, which provides cash assistance payments to low-income families with children has declined by 86 percent on an inflation-adjusted basis (see the box below for a discussion of contributing factors). In addition, the Child Development and Care Program – previously administered in the Department of Health and Human Services but now housed in the Department of Education – has seen a 58 percent inflation-adjusted funding decline from its FY2001 level (Figure 9).

Figure 9: Inflation-Adjusted Funding Growth by Function, FY2001 to FY2024 (budgeted)



Source: Research Council analysis of FY2001 and FY2024 state appropriations in these areas.

Michigan's Cash Assistance Safety Net

In 1996, Congress and the Clinton administration enacted the Personal Responsibility and Work Opportunity Act. A major goal of the legislation was to "end welfare as we know it" by enacting new work activity requirements for cash assistance recipients and allowing states to establish time limits on the receipt of cash assistance. The law also established a new Temporary Assistance for Needy Families (TANF) block grant for states, replacing the former Aid to Families with Dependent Children (AFDC) program under which states received uncapped matching funds to support public assistance programs for low-income families.

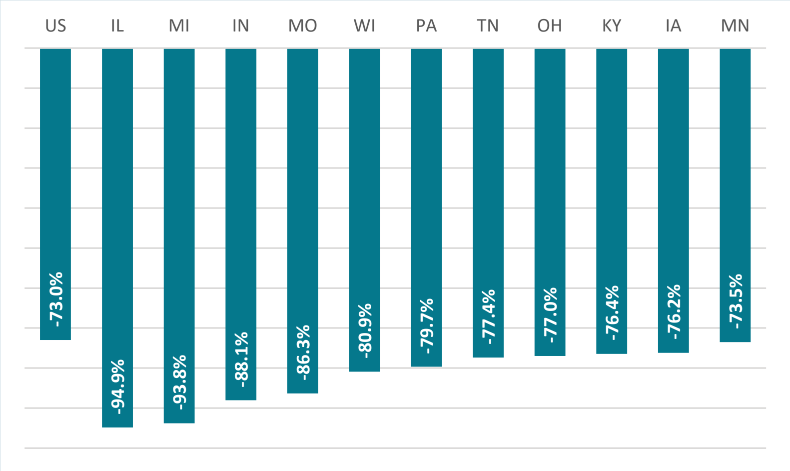
While capping federal funding to states, the block grant structure greatly expanded the flexibility of how the federal funding could be used. New TANF funding could still be used for assistance programs but could also be used to support work-related activities like job preparation and training as well as programs to encourage marriage and two-parent families and to reduce the incidence of out-of-wedlock births.

In the 25 years that followed enactment of welfare reform, states have largely used this new flexibility to shift TANF funds away from cash assistance. Often, TANF is used to finance programs previously funded with state dollars.[2] In Michigan, the most notable example is the state's continued use of TANF funds to finance college scholarship programs that had previously been financed with state General Fund revenue. In FY2021, Michigan allocated over $104 million in TANF revenue for the scholarships, more than 13 percent of its total annual block grant allocation.

[2] Pew Charitable Trusts, States Raid Fund Meant for Needy Families to Pay for Other Programs, July 24,2020.

Between 1990 (pre-TANF, AFDC-funded assistance) and 2020, the number of low-income families receiving cash assistance had declined by 73 percent across the country. In Michigan, however, the TANF assistance caseload had fallen by almost 94 percent during this period (Figure 10). Only Illinois has experienced a greater decline among Michigan's neighboring comparison states, and only two other states (Louisiana and Mississippi) saw larger declines nationally.

Figure 10: Decline in TANF Cash Assistance Caseloads, Michigan and Select States, 1990 to 2020



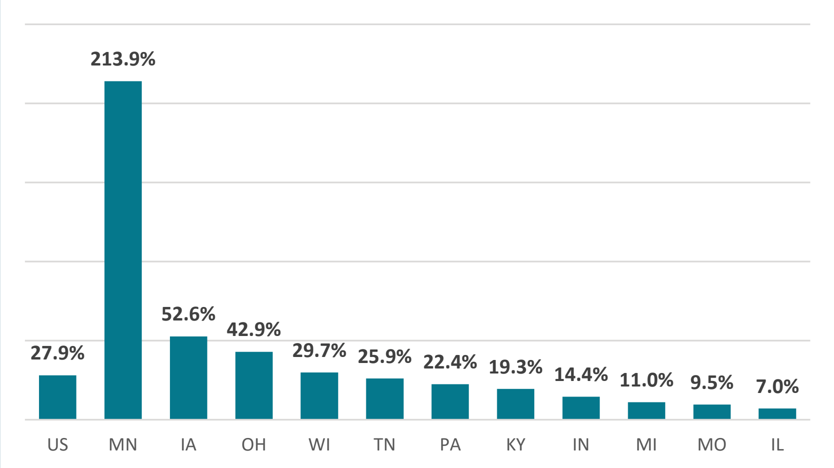
Source: Calculations based on U.S. Department of Health and Human Services data on historical TANF caseloads.

Michigan's caseload decline was accelerated by the implementation of stricter 48-month time limits on the receipt of cash assistance by a given family. Michigan's average monthly cash assistance caseload was 79,660 families during FY2011 but fell to 23,407 families just five years later in FY2016.

Nationally, while these caseload declines partly reflect both strong economic and employment growth through much of this period and the impact of the new "welfare-to-work" program emphasis, data also show many vulnerable families remain who are not receiving cash assistance. Further, the extent to which state programs are serving poor families varies dramatically across the country. Figure 11 examines the ratio of each state's TANF cash assistance caseload to the estimated number of families in that state who have incomes that fall below 50 percent of the federal poverty level.

Michigan's ratio is third lowest among the Midwest states and ranks 36th nationally. While it can be argued that Michigan's cash assistance was at one time "too big", the data show that the current program leaves many vulnerable families without a cash assistance safety net.

Figure 11: Ratio of TANF Cash Assistance Caseload to Families Below 50 Percent of Federal Poverty Level, 2020



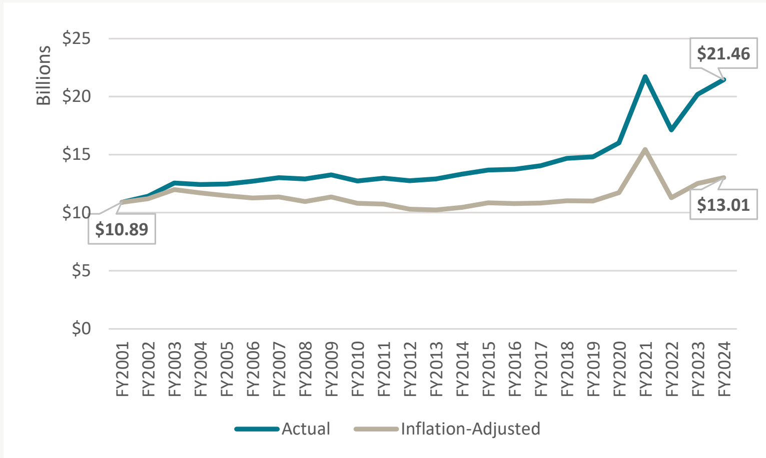
Source: Calculations based on U.S. Department of Health and Human Services data on historical TANF caseloads.

K-12 School Aid

The School Aid budget provides funding to traditional K-12 school districts, public charter schools, and public preschool programs. It is primarily funded with tax revenue dedicated to the School Aid Fund, and as was noted in the previous section, the School Aid Fund did not experience the significant revenue declines in the 2000-2010 period that affected GF/GP revenue. For this reason, the School Aid budget saw very slow, but positive, revenue growth between FY2001 and FY2020 before seeing revenues spike between FY2020 and FY2024 due to both the state's revenue boom during the COVID years and very large rounds of federal support related to addressing COVID-related challenges (Figure 12).

Actual appropriations nearly doubled across the full period. On an inflation-adjusted basis, funding grew by 19.4 percent.

Figure 12: School Aid Funding, FY2001 to FY2024 (budgeted)

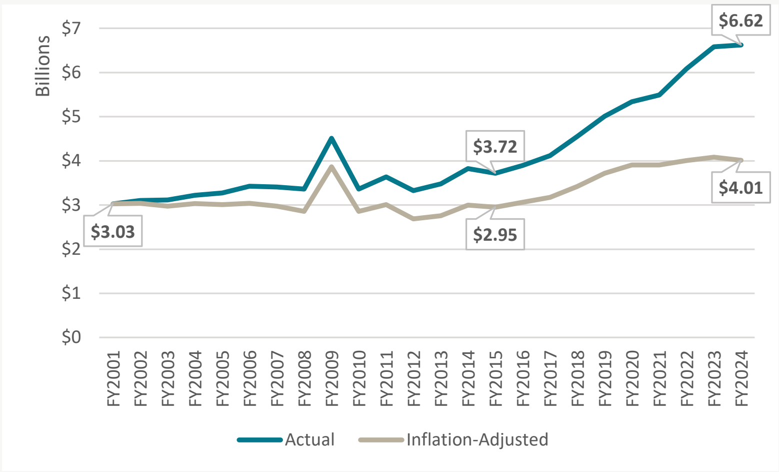


Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

Transportation

The Department of Transportation is funded primarily with dedicated state revenues from motor fuel taxes and vehicle registration fees along with revenue from the federal government. For decades, a persistent challenge was that these dedicated revenue streams grew slower than the costs of maintaining and repairing roads and other transportation infrastructure. As result, overall road conditions deteriorated. Figure 13 shows that while the overall budget experienced slow growth between FY2001 and FY2015, it actually declined marginally on an inflation-adjusted basis.

Figure 13: Transportation Funding, FY2001 to FY2024 (budgeted)



Source: Senate Fiscal Agency, Year-End Appropriation Reports and Budget Tracking documents

That trajectory changed upon enactment of a 2015 road funding package that raised the state's motor fuel tax rate, raised motor vehicle registration fees, dedicated $600 million per year in income tax revenue to road infrastructure, and, beginning in 2022, indexed the motor fuel tax rate to inflation to allow it to automatically increase over time. These enhancements, along with increased federal support for transportation infrastructure, have helped to boost funding since FY2015. On an inflation-adjusted basis, Transportation funding has now grown by 32 percent from its FY2001 level.

While transportation revenues still fall well below estimated funding needs, the revenue picture has at least improved.

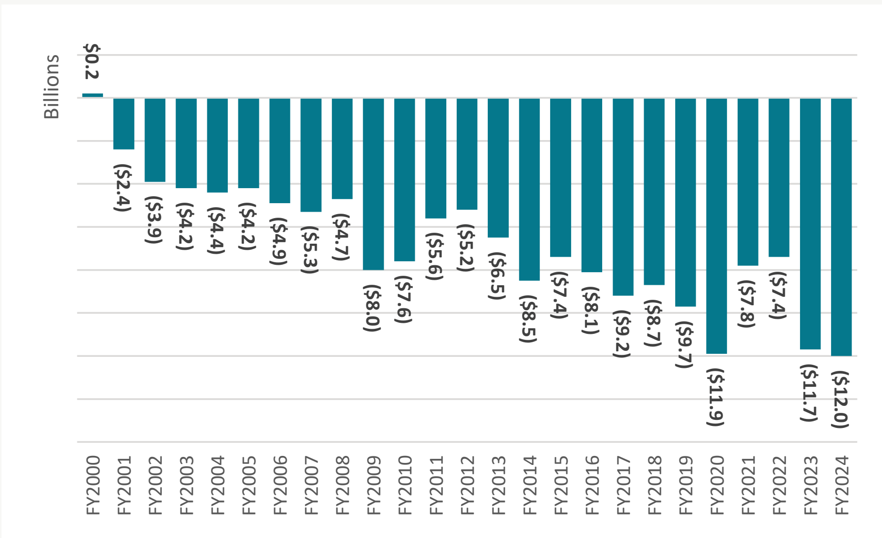
Strength: Capacity to Generate Revenue

The State of Michigan currently has few relevant barriers to its revenue-generating capacity – a situation much different from that of the state's local governments, as is outlined in the next section of this report. State policymakers generally have the ability to raise revenue through changes to tax rates and/or tax bases by enacting legislation.

On paper, the most significant restriction on state revenue is the state's constitutional revenue limit. Approved as part of the Headlee Amendment by voters in 1978, Article IX, Section 26 of the Michigan Constitution limits total state revenue in any given fiscal year to no more than 9.49 percent of total state personal income from the previously completed calendar year. If revenue exceeds this limit by one percent or more, the Constitution provides that taxpayers receive a prorated refund of the excess revenue based on their income and business tax liability.

In reality, however, the revenue limit has largely become a moot issue. Since FY2000, state revenue has grown much slower than personal income. As such, a large gap has opened between actual revenues and the calculated revenue limit. Based on current revenue estimates, FY2024 state revenue is expected to fall $12 billion below the constitutional limit; that gap represents just over 28 percent of total projected state revenue of $42.1 billion (Figure 14).

Figure 14: State Revenue Relative to Constitutional Limit, FY2000 to FY2024



Source: House Fiscal Agency, FY 2023-24 Appropriations Summary and Analysis, September 2023

More recently, a separate revenue cap was established within Michigan's Income Tax Act. In 2015, a new income tax rate "trigger" was added as part of legislation designed to boost state transportation funding.[3] The trigger was designed to automatically reduce the state's income tax rate from its current 4.25 percent following any fiscal year in which state GF/GP revenue grew sufficiently faster than inflation. Notably, the very strong GF/GP revenue growth experienced in FY2022 activated the trigger, and the state's income tax rate for 2023 has dropped to 4.05 percent as a result. A March

[3] See the Senate Fiscal Agency analysis of Senate Bill 414 of 2015 (enacted as Public Act 180 of 2015) for a fuller description of the mechanics of the rate trigger.

Attorney General opinion has determined that this rate reduction will be temporary in nature, with the rate returning to 4.25 percent in 2024.[4]

Even with the rate returning to 4.25 percent, the large revenue impact of the major tax relief legislation enacted in March 2023 is expected to push GF/GP revenue down to a level far below the inflation-adjusted cap. A Citizens Research Council analysis from early 2023 found that GF/GP revenues are likely to fall around $3 billion below their capped level under the 2015 law by FY2025.[5] In short, then, this new GF/GP revenue cap will also likely become moot as the gap between actual and capped revenue widens.

Michigan still has constitutional provisions in place that limit the rate and base of certain major taxes. Article IX, Section 7 of the Constitution prohibits the state and local units of government from imposing any form of graduated income tax. Without a statewide vote to amend this provision, Michigan could not, for instance, assess a higher income tax rate on persons with higher income levels or any certain types of income like capital gains or other investment income.

Similarly, Article IX, Section 8 caps the state's sales tax rate at 6 percent and specifically excludes food and prescription drug purchases from the sales tax's base.

Generally, however, state policymakers have significant latitude to adjust tax rates and tax bases to generate revenue through changes to state statutes.

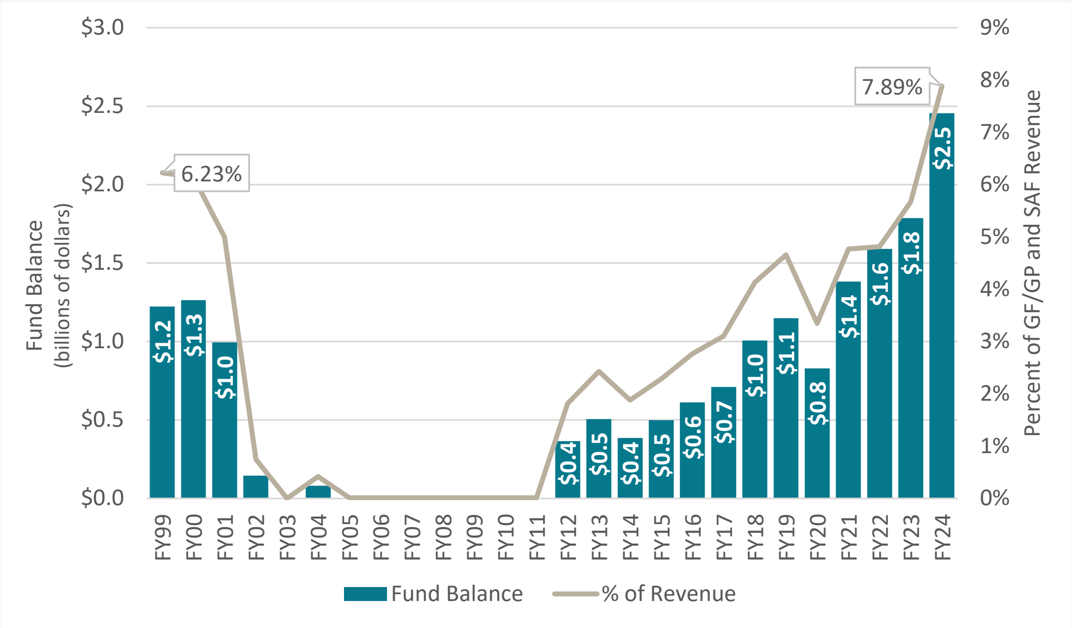
Strength: "Rainy Day" Reserves Create a More Recession-Proof Budget

The state's improved revenue picture has allowed it to build up substantial reserves that ensure it is well-prepared for the next economic downturn. Between FY2022 and FY2024, the state committed an additional $380 million to Michigan's Budget Stabilization Fund (BSF) – commonly referred to as the "Rainy Day Fund".

The BSF balance is expected to approach $2.0 billion by the end of FY2024; equivalent to about 6.1 percent of combined revenue from the state's two major revenue funds: the General Fund and the School Aid Fund.

The FY2024 budget also included a $450 million deposit into a new School Aid Budget Stabilization Fund (SABSF) designed as a buffer for programs funded through the School Aid Fund (Figure 15).

Figure 15: Michigan's Budget Stabilization Funds, FY1999 to FY2024 (budgeted)



Source: House Fiscal Agency

[4] Michigan Attorney General Opinion No. 7320, March 23, 2023.

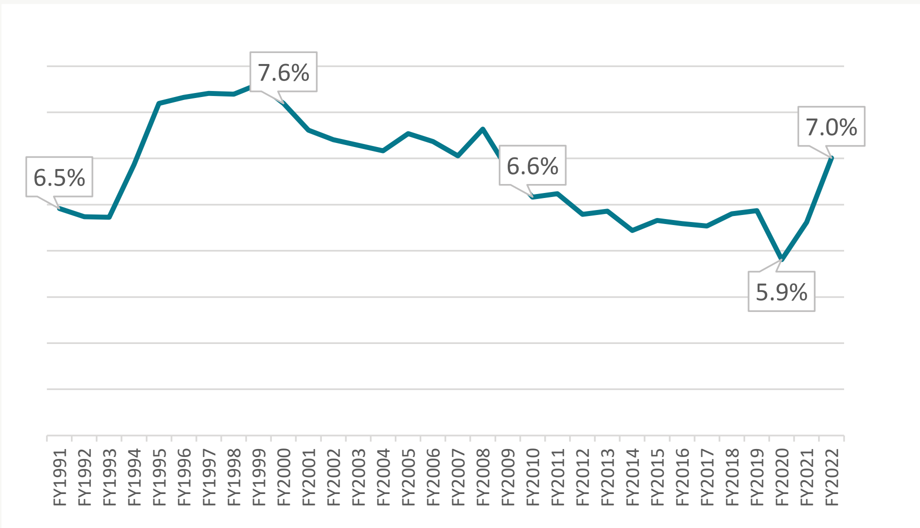
[5] Citizens Research Council, Analyzing the Governor's FY24 Budget Recommendation, February 28, 2023.

Taken together, the combined BSF and SABSF balances give the state just over $2.5 billion in revenue reserves – just shy of 7.9 percent of combined GF/GP and SAF revenue. A recent stress-test analysis conducted by Moody's Analytics[6] suggests that states need reserves equivalent to around 11 percent of general revenues to navigate a recession without having to increase taxes or make budget cuts. Michigan's reserves still fall short of that recommendation, but the state still has a significant revenue buffer to protect the budget from an unexpected revenue decline.

Michigan's Low Tax Burden

It is notable that data show Michigan is already a relatively low tax state, and the recent 2023 tax law changes should keep Michigan near the bottom of all states in terms of tax burden. The state generated $40.1 billion in tax revenue in FY2022; that was equivalent to 7.0 percent of all Michigan personal income (a general approximation of residents' ability to pay taxes). Three decades earlier, the percentage in FY1991 was 6.5 percent; so the state's effective tax rate has increased somewhat over the last 30 years (Figure 16).

Figure 16: State Tax Collections as Percent of Personal Income, FY1991 to FY2022



Source: House Fiscal Agency, FY 2023-24 Appropriations Summary and Analysis, September 2023

However, it is important to note that state tax revenues are used to fund more services today than they were 30 years ago. In particular, funding for Michigan K-12 schools experienced a major shift from local property taxes to state taxes in the mid-1990s. In 1994, Michigan voters approved Proposal A which amended the State Constitution to reform the state's financing of K-12 schools. Those reforms eliminated most school operating millages at the local level and replaced the local revenue with new state revenue generated primarily from an increase in the state's sales and use taxes from four percent to six percent and the establishment of a new six mill State Education Tax.

This shift from local to state financing of K-12 schools initially pushed up the state's tax burden, but state tax policy changes since that time – including reductions to the state's income tax rate and reforms to state's business taxes – had gradually reduced the burden to below its pre-Proposal A level by FY2020. The COVID-related revenue boom pushed the percentage back up over the last two fiscal years, but the impact of the 2023 tax reductions should reverse the trend in future years.

Combining state and local taxes, a recent analysis shows that Michigan ranks 46th among all states in effective tax burden. Just being at the 11.2 percent national average would provide significantly more resources to tackle many of the state's issues. Only Tennessee ranked below Michigan among the 10 neighboring states (Figure 17).

[6] Moody's Analytics, Stress Testing States: Looking Toward the Next Recession, October 2023. https://www.moodysanalytics.com/whitepapers/pa/2022/stress-testing-states-looking-toward-the-next-recession

Figure 17: State and Local Tax Burden by State, 2022

State	Effective Tax Rate	National Rank
Illinois	12.9%	7
Minnesota	12.1%	11
Iowa	11.2%	18
Wisconsin	10.9%	20
Pennsylvania	10.6%	24
Ohio	10.0%	28
Kentucky	9.6%	34
Indiana	9.3%	38
Missouri	9.3%	38
Michigan	8.6%	46
Tennessee	7.6%	49

Source: Tax Foundation, State and Local Tax Burdens, Calendar Year 2022

The State Budget Going Forward

The state revenue boom during the COVID pandemic period provided Michigan with an opportunity to re-shape its budget and revisit decisions made during the times of severe budget strain. When deliberations began on the FY2024 budget, state GF/GP revenue was expected to exceed baseline spending (effectively, this represents ongoing spending built into the current budget plus known spending pressures like Medicaid and Human Services caseloads) by close to $1.4 billion. School Aid Fund revenues were expected to exceed baseline costs by $1.1 billion.[7]

This combined $2.5 billion ongoing revenue surplus provided substantial room to make permanent changes to the state's budget and revenue structure. However, state policymakers have now enacted the FY2024 budget, and while that budget included significant new ongoing investments in public programs, 2023 also saw major tax reforms that will return a significant amount of that surplus revenue back to taxpayers in the form of permanent tax relief.

The good news is that state revenue growth is expected to continue and that should provide room for budget growth in FY2025 and beyond. However, that growth will look more "normal" allowing for inflationary type adjustments. This research series has identified a number of key areas where additional public investment may be necessary to address Michigan's challenges related to an aging population, talent attraction and retention, public infrastructure, and the state's education system. Major investments in any of these areas will likely require either new revenue or the redirection of current revenue from existing programs or functions.

Local Government

Michigan local governments are dependent on the economic and financial health of the state. This can be a challenge for local governments as gubernatorial changes have tended to bring a change in party and changes in priorities. The state is often operating without a comprehensive long-term economic plan or strategic direction that transcends shifts in political leadership. Policy decisions are often made based on immediate fiscal impacts to the state government and the concerns of current policymakers without a full understanding of the long-term implications of many decisions or their impact on other levels of government (e.g., cuts to state revenue sharing to balance the state budget impact the ability of counties, cities, villages, and townships to fund critical public services).

This section will discuss the local government system, including revenues, service provision, and local governance. A few major themes arise from this discussion, 1) the local finance system needs to be revamped to include diverse revenues that better reflect local economies; 2) a greater focus is needed on regionalism for public revenue generation, service provision, and overall governance; and 3) local governments play the lead role in developing a sense of place that is important for retaining and attracting residents.

Michigan's local government finance system does not provide its local governments (i.e., counties, cities, and townships) the resources needed to afford quality of life services that will retain and attract people. The system taxes and provides services at the most local level even though economies are regional in nature. While people and businesses often act and think regionally, local governments are defined by the dotted lines on a map and lack the incentive to think beyond their geographic boundaries.

The system places a heavier burden on low-income and minority communities by leaving low-property value communities without any recourse other than continually raising property tax rates to fund services. It creates a cycle where those

[7] Michigan Senate Fiscal Agency, Summary of the FY2022-23 Appropriations Conference Reports, July 6, 2022, Tables 4 and 5.

with the means to leave for other lower-tax communities do so and those that are left behind must pay even higher taxes to fund basic services. The system also incentivizes behavior that is focused on a local unit's immediate needs, rather than what might be best for other communities, regions, or the state. These behaviors include increasing property tax rates, expanding development and urban sprawl, and discouraging collaboration among local governments in revenues, governance, and service provision. In fact, Michigan's local finance and governance system can often pit local governments against each other rather than incentivize them to work together for the good of the region and the state.

Revenues

The primary own-source revenue options for local governments in Michigan are the property tax and the city income tax. Michigan local governments are more constrained in their tax options than those in many other states (Figure 18). The other main revenue source for local governments is unrestricted state revenue sharing.

Property Tax

The property tax is used by every type of local government, from general purpose governments to special authori-

Figure 18: Local-Option Taxes Authorized in the Great Lakes States

	Property Taxes	Income Taxes	Retail Sales Tax	Transportation Taxes	Utility Users' Taxes	Sin Taxes	Tourism Taxes	Entertainment/ Admissions Taxes	9-1-1 Phone Taxes	Sharing Economy Taxes	Total
Iowa	x	x	x		x	x	x			x	7
Illinois	x		x	x	x	x	x	x	x	x	9
Indiana	x	x		x		x	x	x			6
Kentucky	x	x			x			x	x		5
Michigan	x	x		+	*	*	x		x		4
Missouri	x	x	x	x	x	x		x	x		8
New York	x	x	x	x	x	x	x		x		8
Ohio	x	x	x	+	x	*	x	x	x		7
Pennsylvania	x	x	x	x		x	x	x		x	8
Tennessee	x		x	x	x	x		x		x	7
Wisconsin	x		x	x			x		x		5

Source: Citizens Research Council, Report 399: Diversifying Local-Source Revenue Options in Michigan
* Only authorized to one local unit
+ State taxes shared with local units of government
Notes: This table highlights which states allow at least some local units to levy a tax – does not mean that all local units within the state can levy the tax.
Transportation taxes include motor fuel and vehicle registration.
Sin taxes include alcohol, tobacco, marijuana, casino gambling, and soda/sugar.
Tourism taxes include restaurant, hotel/motel, and vehicle rental.

ties, to fund a variety of services. For many, the property tax is their only own-source revenue. Individually, the property tax levy by any city, township, county, or school district is not overly burdensome. However, because many local governments overlap each other, these tax levies stack to create tax burdens that are burdensome in some places. The tax burden on some Michigan homeowners and businesses in some cities are among the highest in the nation.[8]

As the property tax burden has grown for taxpayers over the years, they have pushed back with property tax limitations to moderate changes in year-to-year growth in their tax burdens. These included an assessment limit (the taxable value measure created by Proposal A of 1994) that limits how much a taxpayer's property value can increase year-to-year, and a levy limit (a section of the Headlee Amendment) that restricts how much tax revenue a jurisdiction can take in year-over-year. In addition, voter approval is necessary for all new taxes and increases in tax rates. The Michigan property tax system operates under a restrictive framework that consists of various statutory rate limitations, a constitutional levy limit, and a constitutional assessment limit.

Michigan's property tax limitations[9] interact and build on each other. Having the tax limitations in place yields less revenue than having no tax limitations unless tax rates are increased. But the system was impacted by the Great Recession (2007-2009)[10], which led to large declines in market values. The two tax limitations together kept tax bases from declining further than they could have without them in place. However, since the Great Recession, the interacting tax limitations have led to slow tax base growth and created a disconnect between real estate market values and tax bases.

The interaction of these tax limitations constrains the growth of property tax revenues so that there is little differentiation between vibrant local governments successfully creating a sense of place welcoming to residents and businesses and those that struggle to do so. It creates pressure for local governments to increase tax rates, which works counter to community and economic development, and incentivizes local governments to permit new development, which facilitates urban sprawl and is unsustainable.

Furthermore, the property tax is constrained because it is inadequate to serve as the sole source of local government revenue in Michigan's modern economy. For almost a century, the state used revenue sharing to supplement the property tax. Revenue sharing provides local governments with diverse revenue streams but centralizes the revenue-raising function at the state level. As we will discuss below, revenue sharing has been cut drastically over the years and local governments have been overly dependent on the property tax.

The primary taxes (income, sales, etc.) collected by the federal and state governments can recover from recessionary conditions simply through growth in the tax bases during economic expansions; however, Michigan's property taxes do not respond to post-recession expansions because of the tax limitations. This leads to situations where property tax revenues can fall quickly and substantially like they did during the Great Recession but increase at no greater than the rate of inflation once the economy starts expanding.[11]

Strengths of Property Tax. The property tax as a funding source for local governments has many strengths. Most importantly, it is a stable tax that provides reliable revenue for local governments. The property value and revenue declines experienced during the Great Recession were unusual – the property tax is generally stable throughout recessionary periods.[12] It is an immobile tax source that tends to impose less of a drag on the economy than other taxes.[13] Michigan's property tax system, with the limitations in place, provides consistency for taxpayers and local offi-

[8] The Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, 50-State Property Tax Comparison Study For Taxes Paid in 2022, August 2023, https://www.lincolninst.edu/publications/other/50-state-property-tax-comparison-study-2022.

[9] Citizens Research Council of Michigan. (2021). Report 411: Michigan's Overlapping Property Tax Limitations Create an Unsustainable Municipal Finance System. https://crcmich.org/publications/michigans-overlapping-property-tax-limitations.

[10] It is important to note that the Great Recession was a unique situation and the only period in recent history that saw severe property value declines. However, those declines set many Michigan communities back substantially on their property tax bases and revenues.

[11] Citizens Research Council of Michigan. (2018). Report 399: Diversifying Local-Source Revenue Options in Michigan. https://crcmich.org/publications/diversifying-local-source-revenue-options-in-michigan.

[12] Citizens Research Council of Michigan. (2020). Blog: Will Property Taxes be Immune to the Effects of COVID-19? https://crcmich.org/will-property-taxes-be-immune-to-the-effects-of-covid-19.

[13] Langley, Adam H. and Youngman, Joan. (2022). Lincoln Institute of Land Policy. Policy Brief: Property Tax Relief for Homeowners. https://www.lincolninst.edu/publications/policy-briefs/property-tax-relief-homeowners.

cials as taxpayers know their tax burden cannot grow by more than inflation or five percent every year (until they sell their house) and local officials know how much revenue to budget for year-to-year.

Weaknesses of Property Tax. Michigan's current property tax system is inequitable for communities and taxpayers. Communities with growing populations and land to develop (i.e., mainly exurbs and rural areas within commuting distance of a central city) do better than built-out communities (i.e., urban central cities) under the tax limitations because their tax base can grow with the new development that tends to favor and locate to undeveloped green spaces.

A 2021 report examined a cross section of local governments to analyze the interaction of Michigan's tax limitations with real estate markets.[14] Selected cities and townships were grouped as urban, suburban, exurban, or rural communities according to their geographic proximity to a core city and the use of the land. It shows how much the taxable value of property has grown in each community. The communities with the fastest growing tax bases tend to be more exurban or rural in nature. For instance, Allendale Township's tax base (Ottawa County) grew 552 percent from 1994 to 2020, Oakland Township's tax base (Oakland County) grew 345 percent, and Grass Lake Township's tax base (Jackson County) grew 282 percent. This stands in contrast to the City of Jackson's tax base that grew only 66 percent over those 26 years, the City of Adrian's tax base that grew only 42 percent, the City of Farmington Hills' tax base that grew 38 percent, or the City of Pontiac's tax base that grew only 8 percent.

Without raising property tax rates, cities and inner-ring suburbs that have little undeveloped land, as well as rural areas with stagnant population growth, have no recourse to keep tax revenue growth at the rate of inflation and growing with the economy. Many urban and suburban areas have redeveloped land and revitalized neighborhoods and downtowns to invest in their communities, but they do not see tax revenue growth from this type of investment. The tax system restricts revenue growth to additions and sales; increases from investment in property cannot increase taxable value beyond inflation. When property is sold and reverted to market value, the tax system treats that pop-up as revenue growth and requires the tax rates to be rolled back. This prevents communities with turnover in their properties from benefitting from those sales and increases in property values. Urban and suburban communities generally have the highest property tax rates of all types of local governments.

The system is not sustainable because the growth of property tax revenue largely relies on new development or increases in tax rates. Land is finite and cannot continue to be developed indefinitely. The state continues to increase sprawl while the population is stagnant. In addition to creating an inefficient use of tax dollars, it is creating pressure to increase tax rates. Most counties, cities, and townships had higher tax rates in 2020 than they did in 2004.[15] Tax rates increased for reasons other than just constraints on the tax base, but, whatever the reason, local governments cannot perpetually increase tax rates. Statutory caps and taxpayer patience create upper bounds.

Additionally, the modified acquisition property value system[16] instituted by Proposal A creates inequities for taxpayers. That is because property owners with similar market values are valued differently for purposes of taxation. This creates situations where a new property owner could pay substantially higher property taxes than their neighbor who has owned an identical property for many years. These differences in taxes provides a disincentive for households to move by creating a lock-in effect wherein homeowners who enjoy a substantial tax benefit become less likely to relocate because the cost of holding the property is lower and the tax benefits are lost once the property is sold. This is not unique to Michigan. Research has found that states with tax limitations (e.g., California) find that newer homeowners shoulder a larger share of the tax burden.[17] Good tax policy does not distort the market like this.

Michigan's property tax system devalues revitalization and redevelopment and encourages urban sprawl. Vibrant communities depend on tax systems that benefit from their own revitalization while also protecting taxpayers from unlimited growth and unpredictability in their property taxes. The current property tax system rewards the wrong

[14] Citizens Research Council of Michigan. (2021). Report 411: Michigan's Overlapping Property Tax Limitations Create an Unsustainable Municipal Finance System. https://crcmich.org/publications/michigans-overlapping-property-tax-limitations.

[15] Citizens Research Council of Michigan. (2022). Memorandum 1169: Local Governments Respond to Property Tax Base Limitations by Raising Tax Rates. https://crcmich.org/publications/raising-property-tax-rates.

[16] A modified acquisition value system determines the value of property for tax purposes by using the purchase price adjusted annually by inflation, regardless of market value increases.

[17] Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence. (2022). 50-State Property Tax Comparison Study: For Taxes Paid in 2021. https://www.lincolninst.edu/publications/other/50-state-property-tax-comparison-study-2021.

behaviors and does not create vibrant regional economies. It is disproportionately impacting low-income communities that are built out and/or not attracting new residents. It impacts new homeowners, who are generally younger and have a lower income than long-time homeowners. Michigan needs a municipal finance system with diverse tax options that can provide more equitable revenue sources and grow with the local economy.

State Revenue Sharing

Michigan's program of unrestricted state revenue sharing is the other main revenue source for many local governments. Many states provide restricted state revenue sharing (e.g., state-collected funds sent to local units for specific purposes such as education), but Michigan sends state-collected revenues to local units to use at their discretion. Revenue sharing was designed to compensate local governments for foregone tax revenue caused by state policy changes that preempted certain local taxes. But, over time, it became a revenue stream to supplement property tax revenue and tie local revenue to the strength of the economy. Originally, all revenue-sharing dollars were sent to local governments on a per capita basis, but, since 1971, the state has attempted to give a portion of revenue sharing greater purpose by directing funds in the statutory revenue sharing program to the local governments with the greatest need, defined as the lack of capacity to fund services from locally collected revenue sources.

Michigan's system of state revenue sharing, as well as other programs of state aid (e.g., highway funding and court funding) were created as part of a specific state policy to contribute state-raised funds to provide some diversity in the revenue structure of local governments in place of local-option taxes. State policymakers agreed to serve in a revenue-raising capacity to capitalize on efficiencies and share state-collected revenue with local governments, oftentimes because the finances of local governments were negatively impacted by statutory changes that exempted parts of the property tax base from taxation.

The constitutional portion of state revenue sharing is the result of a 1946 amendment that dedicated revenues to local governments and schools. It distributes 15 percent of sales tax revenues at a four percent rate on a per capita basis to cities, villages, and townships. The statutory revenue sharing program dedicates 21.3 percent of sales tax revenues at a four percent rate to local governments. Statutory revenues were to be distributed based on formulas that consider unit type, taxable value, and yield equalization.

Strengths of State Revenue Sharing. State revenue sharing helps local government revenue structures benefit from economic growth not reflected in changing property values or property tax revenues. Revenue sharing serves to diversify the revenue structure of local governments in Michigan. For example, local governments did not need a local-option sales tax because they already benefitted from increases in consumption with shared sales tax revenues. It facilitates economic development by diminishing the need for local taxes to be levied at exorbitant and non-uniform rates. And, when it is fully funded, it ensures that a minimal level of services is provided across all jurisdictions.

Weaknesses of State Revenue Sharing. The problem with this system is that it works when state revenues are strong but has proven an easy funding source to cut when state revenues are declining. Time and time again, state policymakers have used revenue sharing dollars to fill state budget holes, leaving local governments scrambling to make up for their revenue shortfalls. For example, the statutory formula passed in 1998 must be appropriated annually and has only been fully funded once (2001).

As noted previously (see discussion of state government finances), there was a sharp decline in total revenue sharing payments between FY2001 and FY2010 in response to state budget challenges. Subsequent growth has restored funding to its FY2001, level but payments are still down 35 percent on an inflation-adjusted basis.

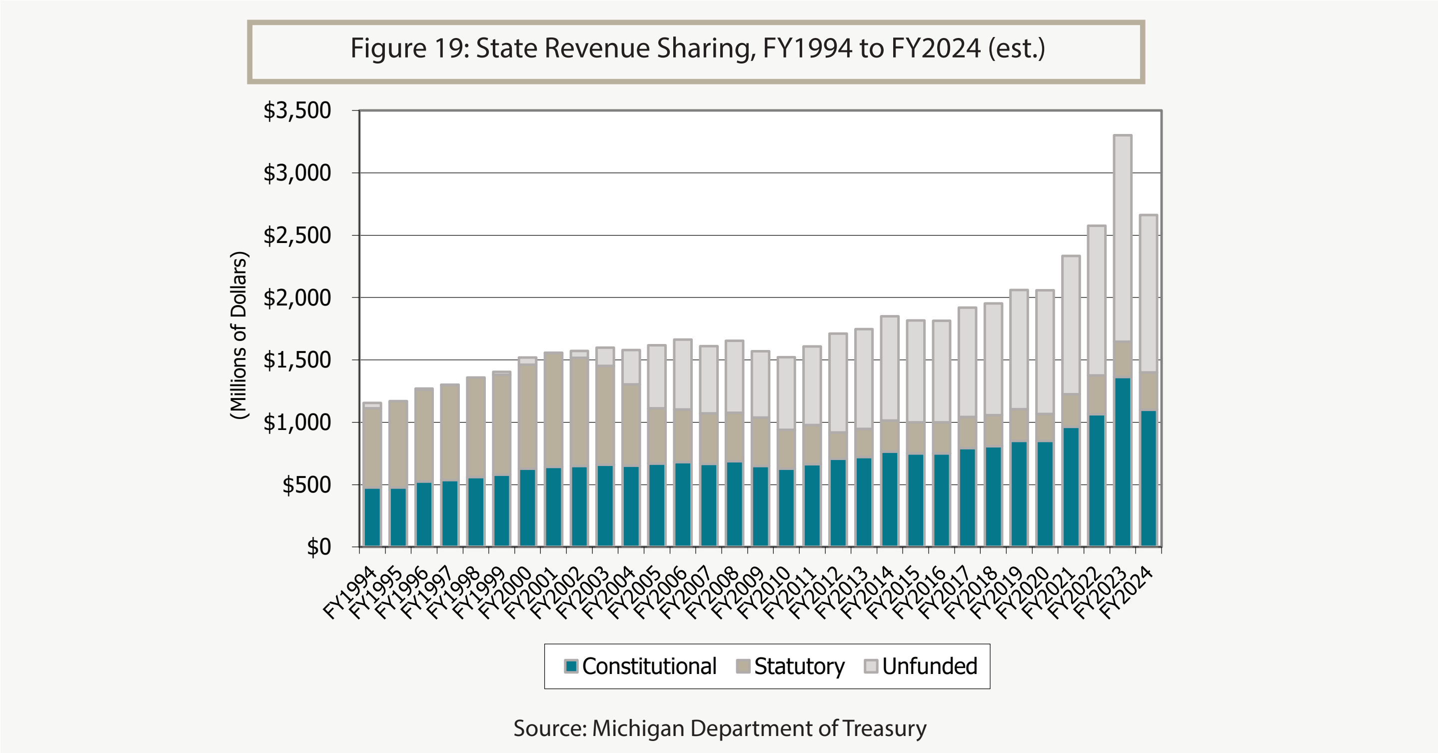


Figure 19 shows the consequence of the state's underfunding of the revenue sharing system. Constitutional revenue sharing payments have to be made. They are shared on a per capita basis. They have grown over the past 30 years. Statutory revenue sharing, a discretionary appropriation took the brunt of the funding reductions. Those payments were made using a weighted formula that sends more to cities, villages, and townships with less fiscal capacity to fund services from local tax sources and with greater service demands. Only about one-quarter of local governments eligible for funding continue to receive statutory state revenue sharing today, and the methodology for determining funding levels has more to do with prior year's funding amounts than any current measure of need or fiscal capacity. The local governments most fiscally challenged were the ones impacted the most by the state's past funding reductions.

Past, as well as potential future, reductions in state revenue sharing distributions to local government are significant because of the proportion that those dollars contribute to local government budgets (especially the budgets of those local units with the most service responsibilities and the least ability to raise their own-source revenue), but also because local governments have lost much of their connection to the prosperity created by economic expansion. It is true that constitutional state revenue sharing has remained unchanged, but the per capita distribution of those dollars lessens the ties to the economy for the population centers that are the locus of economic activity in the state. Although these places host commerce, retail, industry, and other activities that increase state tax revenues, they are rewarded no more than any other local government.[18,19]

If the state is not going to share the revenue it collects, then Michigan local governments should have greater latitude to levy taxes to benefit from economic activity on their own. In the current system, with revenue sharing dollars in peril, the revenues of local government will be nearly completely divorced from economic growth.

[18] Citizens Research Council of Michigan. (2018). Report 399: Diversifying Local-Source Revenue Options in Michigan. https://crc-mich.org/publications/diversifying-local-source-revenue-options-in-michigan.

[19] Citizens Research Council of Michigan. (2015). Report 388: Reforming Statutory State Revenue Sharing. https://crcmich.org/publications/reforming_michigan_statutory_state_revenue_sharing.

City Income Tax

The Uniform City Tax Act of 1964 grants all cities in Michigan the authority to levy a city income tax with voter approval. Other local units in Michigan – counties, villages, and townships – are statutorily precluded from levying a local income tax.[20] Only 24 cities[21], ranging in size from small cities with less than 2,000 residents to the state's largest city with over 620,000 residents, levy a local income tax.

Strengths of Local Income Tax. Motivation for levying an income tax can vary by city, but the benefits include the fact that revenue from income taxes can supplement dwindling property tax revenues or can allow cities with prohibitively high property tax rates to lower their rates. The income tax also allows cities to export the tax to workers that reside in surrounding communities but benefit from city services because they work in the city. Additionally, income taxes diversify revenue sources and allow governments to benefit from economic activity that is not captured by property taxation, such as the value of earned income, investments, and profits. Income tax revenues are more closely tied to the economy than property tax revenues meaning revenues are more cyclical, bringing in higher revenue when the economy is doing well and lower revenue when it is doing poorly. This is a benefit – being more closely connected to the economy, but it makes the tax less stable than the property tax.

Weaknesses of Local Income Tax. The local income tax in Michigan is authorized only to cities, the most local level of government. The weakness of taxing at this local level of government came to light during the pandemic – the tax base depends on people going into the city to work. If a large share of workers continue to engage in remote work, it will likely lead to lower income tax revenues for central cities.[22] Local income taxes can create disincentives to live or work in the cities that levy them. These higher tax burdens can create incentives for people to locate or find jobs in cities that do not levy an income tax; it can also create incentives for corporations to locate in cities without an income tax. However, it is not clear that these disincentives are any greater than those created by city property taxes levied at high rates relative to the surrounding communities. One way to address this concern would be to authorize local-option income taxes at the county or regional level to remove some of the dislocation tendencies associated with these taxes.

Additionally, many of the cities that are levying a local-income tax are central cities with high property tax rates and high poverty rates. Again, a disproportionate share of the taxing burden is on low-income, high-minority population communities.

Organization and Service Provision

Local government organization has changed little since Michigan became a state in the 1800s. General-purpose government is organized into 83 counties, 533 cities and villages, and 1,240 townships that provide a broad, and somewhat overlapping, range of services. They are not sovereign entities but are creatures of the state and derive their power from the constitution and laws of the state.

Governance Structure

Michigan's system of government is characterized by a relatively large number of units. While large cities such as Detroit, Grand Rapids, Flint, and Lansing are generally in the spotlight, most of the cities and villages are small in geographic size and serve small populations. Only a very small number of states have towns or townships authorized to provide a broad range of services akin to the role that Michigan's townships play. While only cities, a subgroup of the villages, and a few counties are empowered by home rule independence, a constitutional deference toward local control gives even those local governments not organized with home rule powers a degree of independence from state dictates.

[20] Citizens Research Council of Michigan. (2011). Memorandum 1103: Local-Option City Income Taxation in Michigan. https://crc-mich.org/publications/local_option_income_tax-2011.

[21] Albion, Battle Creek, Benton Harbor, Big Rapids, Detroit, East Lansing, Flint, Grand Rapids, Grayling, Hamtramck, Highland Park, Hudson, Ionia, Jackson, Lansing, Lapeer, Muskegon, Muskegon Heights, Pontiac, Port Huron, Portland, Saginaw, Springfield, and Walker.

[22] Fongers, Kaleigh. (2022). Grand Rapids Business Journal. Hybrid model stays steady in West Michigan. https://grbj.com/news/real-estate/hybrid-model-stays-steady-in-west-michigan/.

Every resident lives in a county, which is governed by boards of commissioners and varying levels of executive governance depending on how a county is structured. While state law allows for some form of centralized executive power at the county level, most counties are organized under general law with an antiquated governance structure. The result is a complex structure of county government with authority heavily diffused and general responsibility and accountability very difficult to pinpoint.[23]

The city or township (and village in some instances) are the most local forms of government, that which is closest to the people. Every resident lives in either a city or a township; some township residents may also live in a village. Cities and some villages have adopted their own governance charters under home rule powers; townships and some villages are authorized under general state laws that prescribe their governmental structure and powers.

Service Provision. Most service authority in state law is given to cities and townships as the governments closest to the people. However, advances in communication, technology, and transportation make small local governments a less than efficient way to provide services. Furthermore, it discourages communities from adopting a regional focus and policies that benefit the region, which is necessary to create vibrant economies and regions that will attract and retain residents. Take public transportation, for example, a service that could attract young people into urban areas if it is provided effectively throughout a region. It requires a regional focus on policies related to public transportation, such as planning and zoning, and related policies as well as regional funding.[24] These things are hard to accomplish with Michigan's current hyper-local system of governance and service provision.

The Research Council has suggested that counties could provide more services than they currently do as a way to promote a more regional focus in service provision, planning, and taxation across the state. In addition to public transportation, other services that could be provided at a regional level include information technology, administration and general government services, tax collection, elections, property assessing, road maintenance, public safety services, and public works and sanitation services.[25]

Strengths of Governance System. The strengths of the current governance system are that Michigan residents are represented by many, small local governments that are close to the people. As such, it is easy to go to city or township officials to address an issue with a particular service or policy. However, giving more governance authority at the county level would keep governance relatively close to the people.

Removed from the political whims of the state's executive and legislative branches, local governments have the freedom to organize in ways that fit their needs and provide services that best meet the needs of their residents.

Weaknesses of Governance System. The organization of local government in Michigan is antiquated and reflects the state as it was in the 1800s when it was entering statehood. Despite advances in technology, communication, and transportation, local government has not been reorganized to better meet the needs of a modern society. Michigan local government is characterized by many local governments with overlapping geographical boundaries and often overlapping service responsibility and taxing authority. The governance structure of many local units, particularly townships and counties, reflects the 19th century emphasis on a diffused executive function, which is not always suited to modern-day government needs.

Economies today are regional and local government would benefit from a more regional-focused organizational structure. This could be at the county level or at a larger regional level. The Research Council has focused on regions at the county level because county governments are already organized and well-suited to increase their governance and service provision capabilities. It Is not as simple as the state giving more service provision authority to the counties. First county commissioners and Michigan residents will need to consider changes in both the culture of county government and the governance structure of counties. Much could be gained by changing the thinking of counties from standalone entities to multi-purpose function providers for their constituent local units. Strong county

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23 Citizens Research Council of Michigan. (2017). Report 395: Counties in Michigan: An Exercise in Regional Government. https://crcmich.org/publications/counties_regional_service_provider-2017.

24 Citizens Research Council of Michigan. (2019). Report 406: Rethinking Regional Transportation in Michigan's Urban Areas. https://crcmich.org/publications/rethinking-regional-transportation.

25 Citizens Research Council of Michigan. (2017). Report 395: Counties in Michigan: An Exercise in Regional Government. https://crcmich.org/publications/counties_regional_service_provider-2017.

leadership will be needed to gear county services to benefit the local governments and let local governments know that the county is amenable to working with them to achieve change and savings/efficiencies.[26]

The multitude of local governments and deference to home rule also has institutionalized a NIMBY (not in my back yard) culture. City, village, and township boards may take actions to keep economic activities with negative externalities (aggregate mining and wind and solar renewable energy facilities are recent examples) out of their jurisdictions to the detriment of the state and regions. Over time, state officials have responded to this NIMBY culture by nibbling away at home rule and local control.

Opportunities and Threats

Michigan's current local governance and finance systems do not promote a quality of life that has been successful in retaining and attracting people to the state and its communities. Michigan has many strengths, but its local governments have been operating with a local finance system that is too dependent on the property tax and disconnected from the economic activity that occurs locally. It operates with a hyper-local governance system that does not easily allow for collaborative governance at the regional level that would include regional service provision and tax base sharing among local communities. To improve local government organization and finance and make the state more attractive to mobile people, the state and local governments need to work together to address these weaknesses.

Attract New Residents, Especially Young People

The ability of Michigan cities to offer public transportation and develop vibrant central cities is hampered by many aspects of municipal finance and governance. Michigan's rapid transit options are generally limited to long-haul buses and smaller dial-a-ride services. Michigan cities have not been able to coalesce around plans for fixed rail train services, and now that Michigan's urban areas have sprawled so far and wide, and jobs are no longer concentrated in the downtown areas but are spread throughout the regions, it would be difficult to locate rail lines in places that would serve the optimal numbers of riders to make them close to profitable.

Further, most transit services in America rely on regional sales tax revenues as their primary source of revenue. Michigan local governments are precluded from levying local-option sales taxes by constitutional language pertaining to the maximum tax rate and allocation of tax revenues.

Michigan's focus on home rule for its local governments in many ways interferes with efforts to accomplish regional goals such as transit. More than just agreeing on a funding scheme, vibrant communities and successful transit can be accomplished with transit-oriented housing, walkable communities providing access to transit stops, commercial buildings close to transit stops, and other features that benefit transit users.

Finally, as will be discussed in the following section, the ability of cities to offer amenities conducive to what is viewed as vibrant cities is constrained by Michigan's municipal finance system. The cities that are attracting people to their vibrant downtowns fare only marginally better than those that either do not share that goal or are failing to attain that goal.

Provide Local Governments with Stable Revenues that are Connected to the Economy

Michigan has become a low-tax state. The Tax Foundation ranked Michigan's tax burden in 2022 as 46th highest with a state-local effective tax rate of 8.6 percent (see Figure 17 on page 17). States ranged from an effective tax rate of 4.6 percent in Alaska to 15.9 percent in New York.[27] In contrast, Michigan ranked 26th in 2000 with an effective tax rate of 9.5 percent.[28] Being a low-tax state can be a benefit, but only if a state is also attracting residents and providing desired services at the state and local government level. Underfunded local governments result in a poor quality of life, which makes it difficult to retain and attract residents.

[26] Citizens Research Council of Michigan. (2017). Report 395: Counties in Michigan: An Exercise in Regional Government. https://crcmich.org/publications/counties_regional_service_provider-2017.
[27] York, Erica and Walczak, Jared. (2022). The Tax Foundation. State and Local Tax Burdens, Calendar Year 2022. https://taxfoundation.org/publications/state-local-tax-burden-rankings/.
[28] The Tax Foundation. (2000). State and Local Tax Burdens, 1977-2012. https://taxfoundation.org/state-and-local-tax-burdens-historic-data/.

The problems with local government revenues are discussed above: local governments are too reliant on the property tax, and they do not have diverse revenue sources that can serve them in both times of economic hardship and economic expansion. The local property tax is generally a stable tax and a good source of local revenue in combination with other local taxes that are less stable during economic downturns but more connected to the economy, such as local sales or income taxes. Local governments do not currently have access to other tax sources, and it would require state law (or, in some instances, amending the state constitution) to allow local governments to levy more diverse taxes. The Research Council put out an in-depth report on local tax sources which discusses if and how the state could allow local governments in Michigan to levy different types of taxes.[29] If a state law allows for a new local tax, it still cannot be levied by a local government without voter approval.

Property taxes are connected to changes in property values, income taxes are connected to changes in employment and income levels, and sales taxes are connected to purchases and sales. These are different aspects of the economy, and a broad tax policy draws on all of them. Another option is to increase state revenue sharing dollars so that the state provides diverse revenues to local governments. This is only successful when those funds cannot be diverted to meet state budget needs, which would require reforming Michigan's current system.[30]

Regional Governance: Give Counties More Tax Authority and Service Responsibility

Counties were originally organized to be agents of the state, carrying out state laws and functions at the county level. Most local services are provided by cities and townships that are closer to the people. This system is now antiquated. Traveling and communicating with one's county government is very easy, and many local services can be provided at the county level. However, for increased county collaboration to be successful, counties must view and market themselves as partners, rather than competitors, with their constituent local units. It may also require changing how counties are governed and funded to give them stronger executive authority and increased funding options to provide expanded services.[31]

In this scenario, counties would provide overhead services (e.g., IT services and back-office functions for general government, police, fire, etc.) while local governments focus on placemaking and attracting and retaining residents. This provides a balance across high-tax and low-tax and high-poverty and low-poverty communities throughout a region as counties are made up of both types of governments. This is important because many issues facing local governments transcend local boundaries. Economies are regional and that is why Michigan needs regional governance to address the issues facing local governments.

Better Utilize Regions

Governance and basic service provision at the county level will allow for better regional planning and collaboration, more efficient service provision in many instances (counties can provide services for smaller communities and collaborate with larger cities and townships to provide services most effectively), and tax-base sharing. Local governments with high property values and low tax rates can help fund services across the region. It is important for communities to understand that they cannot excel and attract residents from other states when their neighbors are struggling with high taxes and low service quality. Regions are only as attractive as their weakest area. The state is only as strong as its weakest local government. Tax base sharing and regional planning work together to promote the region as a whole and that is what encourages immigration and keeps residents from leaving a community.

While collaboration among government entities is theoretically easier than consolidation of governments, collaboration at the county level will not be easy. Regional collaboration has been especially hard in Southeast Michigan, but it can be a challenge across the state. People are attached to their local community and hesitant to cede any of its power or authority. It does not help that Michigan residents have self-segregated by where they live; this segments communities across regions and makes collaboration difficult. It is a challenge to cooperate to provide services when our communities are so distinct from each other.

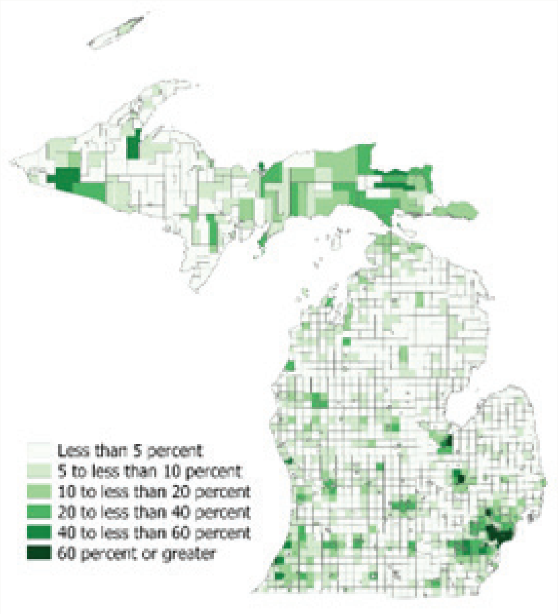
[29] See Report 399: Diversifying Local-Source Revenue Options in Michigan (https://crcmich.org/publications/diversifying-local-source-revenue-options-in-michigan).

[30] See Report 387: Reforming Statutory State Revenue Sharing (https://crcmich.org/publications/reforming_michigan_statutory_state_revenue_sharing).

[31] Citizens Research Council of Michigan. (2018). Blog: Counties should provide collaboration and regional governance. https://crcmich.org/counties-should-provide-collaboration-and-regional-governance.

The U.S. Census Bureau tracks states' and counties' diversity index, which measures the chance that two people from a state or county chosen at random will be from different racial and ethnic groups. Michigan as a state does not rank high with a 45.2 percent chance (32nd out of 51 states, including Washington D.C.). Only 10 counties[32] in Michigan have a rank of 45.2 percent or higher with Michigan's 83 counties ranging from a diversity index of 62.5 percent in Wayne County to one of 9.2 percent in Keweenaw County.[33] Michigan's numbers have improved as Michigan's population becomes more diverse, but for the most part, outside of some major urban centers, the diversity index would be much lower for local communities within each county. Figure 20 from a 2018 report[34] shows that much of Michigan lacks diversity. Ninety-five percent of rural Michigan identifies as white while 74 percent of urban Michigan does.

Figure 20: Percentage Non-White Residents in Total Population by City/Township



Source: U.S. Census Bureau, 2011-2015 American Community Survey Five-Year Estimates

Many believe that regionalism is the future. Michigan's economic struggles throughout much of the 2000s brought home the need to do local government differently. This includes changing how local government is funded, but also how it governs and provides services. It means different groups and communities coming together to fund and provide services that will improve the region and provide benefits to all its residents.[35]

Better Utilize Michigan's Climate and Geography

One of the key things Michigan needs to do over the next 20 years is reverse its stagnant population trends. The state needs to attract mobile workers and individuals that can contribute to a growing economy. At the state and local government levels, Michigan needs to create an environment that people want to live in. It should be easy – Michigan's climate and geography are natural strengths. In an increasingly dry world, Michigan has water. Michigan has an international border. The problem is that the state does not capitalize on these strengths.

[32] Wayne, Ingham, Chippewa, Washtenaw, Saginaw, Oakland, Baraga, Kent, Genesee, and Berrien counties.

[33] U.S. Census Bureau. (2022). State Profile: Michigan. https://www.census.gov/library/stories/state-by-state/michigan-population-change-between-census-decade.html.

[34] Citizens Research Council of Michigan. (2018). Report 400: Exploring Michigan's Urban/Rural Divide. https://crcmich.org/publications/exploring-michigans-urban-rural-divide.

[35] Citizens Research Council of Michigan. (2018). Blog: Problems with the Local Government Fiscal Structure – Is Regional Service Delivery the Solution? https://crcmich.org/problems-with-the-local-government-fiscal-structure-is-regional-service-delivery-the-solution.

The state needs a campaign to attract and retain people. Rather than focusing on tourism, the state needs to market Michigan as an attractive place to live and raise a family. To do that, it needs vibrant communities, good school systems, and job opportunities. Michigan has a strong university system, but it struggles to retain out-of-state (and some in-state) students after graduation.[36] Michigan also needs its educational system (both secondary and post-secondary) to better prepare and connect workers to the jobs available.

At the local and regional level, Michigan needs to fund government at a level that it can provide desired services and a standard of living across a region. Regions need to provide services, like public transportation and education, that attract residents. In the past, cities could thrive and grow regardless of whether they had high taxes or expensive housing, but things are changing and workers are more mobile than ever. This increases the competition that states and regions face to attract residents.[37] It also opens opportunities for Michigan to market its climate and geography and for lakeshore and rural areas to attract residents that can work remotely. However, communities need to provide services and quality of life to attract residents.

Weaknesses Felt in Low-Income Communities First

This section starts by discussing the opportunities facing Michigan related to its local government organization and finance. These opportunities would build on Michigan's strengths and attempt to address the weaknesses in Michigan's local government system. It is important to note, though, that the weaknesses that are discussed throughout this section are being felt first, and often most severely, in Michigan's low-income and majority-minority communities. Without tax-base and service responsibility sharing, communities with low property values have little recourse to raise revenues outside of levying prohibitively high tax rates. This further segregates communities as those with means continue to leave for lower-tax communities.

It creates a system where Michigan's poorest people living in its most struggling communities are paying taxes at rates much higher than their neighboring wealthy communities (and receiving fewer services for those taxes paid). This is important for reasons of equity, opportunity, and fairness – people who are paying high tax rates in low-property value communities deserve better than sub-standard local services. But, even more importantly than that, Michigan is only as strong as its weakest local government. A region is only as strong as its weakest community. A county is only as strong as its weakest constituent local government. The state cannot thrive if it leaves some of its communities behind. Regions cannot thrive unless they are providing services and meeting needs throughout the entire region.

State and Local Government Human Capital

The preceding discussion focused largely on the condition of Michigan state and local government public finances, with particular attention to the economic and fiscal challenges the state and its nearly 1,900 local governments have faced since the early 2000s. Challenges that were borne out of the national 2001 recession and the 2008 Great Recession, but also Michigan's "single state recession" that persisted for much of the first decade of the new century between those national downturns. Restrained state tax revenue growth from these economic slowdowns, combined with several major tax policy changes enacted during this period, required major restructuring of state and local government finances throughout much of the early 2000s and through the Great Recession. This resulted in state budget reductions for several public programs, as well as the cuts to state aid to local governments and public colleges and universities.

[36] Mackay, Hannah. (2022). The Detroit News. Michigan's brain drain: Which colleges lose the most graduates and why they leave. https://www.detroitnews.com/story/news/local/michigan/2022/09/19/michigans-brain-drain-which-colleges-lose-most-graduates-and-why/10143538002/?gnt-cfr=1.

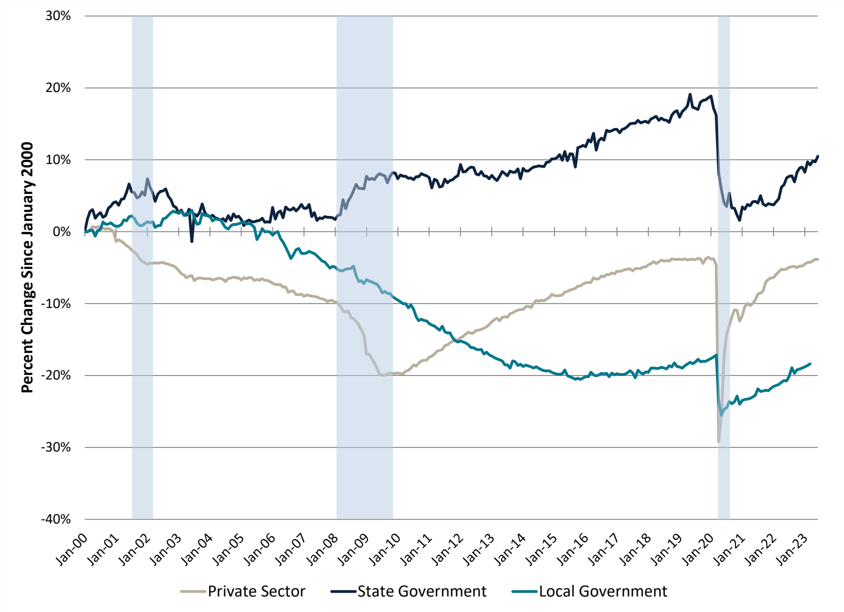
[37] Hendrix, Michael. (2022). Governing: The Future of States and Localities. Why Local Governments Need to Compete to Offer Citizens What They Want. https://www.governing.com/now/why-local-governments-need-to-compete-to-offer-citizens-what-they-want?utm_campaign=Newsletter%20-%20GOV%20-%20Daily&utm_medium=email&_hsmi=226550034&_hsenc=p2ANqtz--OQWeLR0aLU2p0oIEo7Gm4ngaAw4fwmWDOttN4meD0K-pj67MmfZ1u1KywfSUTuGT1rLUVNHagHWEaf2-SDbmD8E7dBQ&utm_content=226550034&utm_source=hs_email.

These budget decisions directly impacted public sector employment levels in the state government and across Michigan's local governments. The human capital impacts arising from state and local budget-tightening during much of the past two decades provide an important insight into the ability of the public sector to respond to current and future challenges, including efforts to address many of the public service demands taxpayers expect from government. This includes services such as providing safe, efficient, and reliable physical infrastructure (e.g., roads, water and sewerage, and electricity), providing police and fire services, and ensuring a healthy natural environment, including water and air quality. Further, sufficient public sector human capital capacity will be needed as state officials consider public policies aimed at retaining current and recruiting new residents to the state, a key future challenge facing the state.

To provide some grounding and context regarding public sector human capital, consider that Michigan's total nonfarm employment was just under 4.66 million jobs in January 2000, but since that time monthly employment totals dropped 4.8 percent to about 4.44 million jobs in August 2023. Of course, there was great variability throughout this period and across different sectors and industries of the economy. The bottom line is that the state's stagnant population growth over the past two decades along with a host of other factors have contributed to a smaller overall employment base.

Figure 21 illustrates the cumulative percent change in seasonally-adjusted monthly employment for both the public and private sectors in Michigan since January 2000 (Note: periods of national recessions are shaded). Public sector employment is mainly comprised of jobs at the state and local level (federal government employment is a small share of the overall public sector in Michigan). At a macro level, state and local government had greater job losses than the private sector, thus changing the state's total employment composition across the two sectors. Today, government jobs account for 13.8 percent of all jobs in the state, compared to 14.5 percent in 2000.

Figure 21: Seasonally-Adjusted Monthly Employment by Sector in Michigan Since January 2000



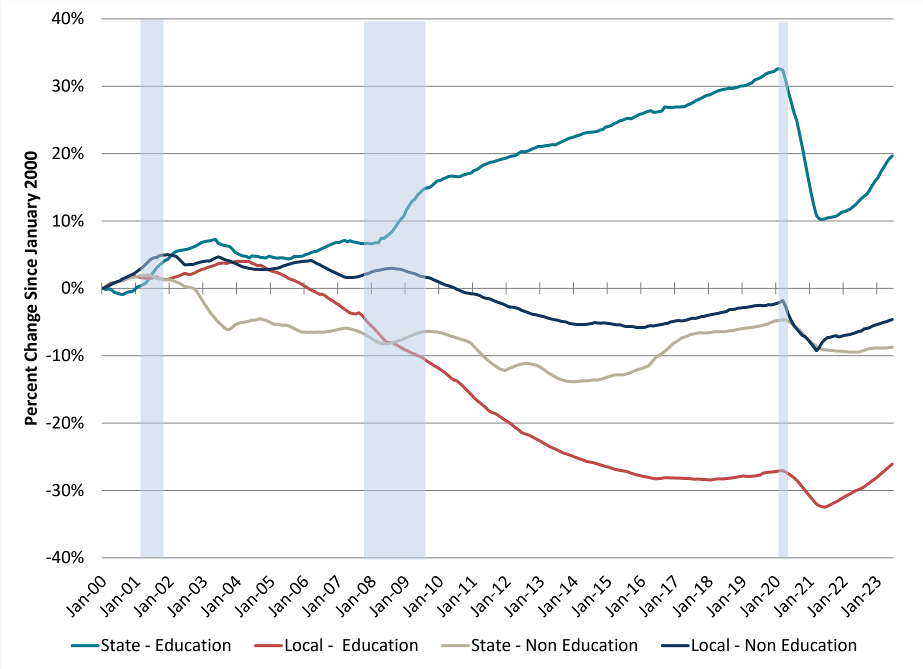
Source: Bureua of Labor Statistics

Looking at the employment experiences presented here, there are a few similarities across the three sectors. One is the steep and immediate job losses experienced during the short-lived COVID-19 pandemic recession in early 2020. With the complete shutdown of the entire world economy early in the pandemic, job losses were ubiquitous in all industries. Similarly, all three sectors saw an immediate and sustained rebound from the monthly employment trough following this recession. This occurred as employers, both private and government, transitioned to remote-work and adopted other workplace arrangements. Another similarity in the employment trends is the sustained long-term slide observed in the private sector and local government arena throughout Michigan's "single state recession" and continuing through the Great Recession.

The overall decline in public sector jobs mentioned above has been driven by the local government sector, which is twice as large as the state government sector. Although there have been losses in some areas of state employment, job losses in local government have been widespread across occupations.[38] The "state government" category used in the federal data includes employees of the State of Michigan, staff at public higher education institutions, and affiliated hospitals. The "local government" category includes jobs in general governmental units (counties, cities, townships, and villages) and special purpose districts (such as K-12 public schools, libraries, and special authorities).

Breaking down the two public employment sectors further reveals that changes varied considerably when education-based jobs are separated from the broader categories. Figure 22 shows the 12-month rolling average of employment by state and local government sub-sectors and highlights the role education jobs have played in driving the long-term trends observed in each sector. State employment in the education sub-sector consists largely of public universities jobs; the only sub-sector that has seen an employment increase (about 20 percent) over the past 23 years. In contrast, other state government jobs, collectively, are down relative to their January 2000 level.

Figure 22: Monthly Public Sector Employment by Sub-Sector in Michigan: 12-Month Rolling Average Since January 2000



Source: Bureua of Labor Statistics

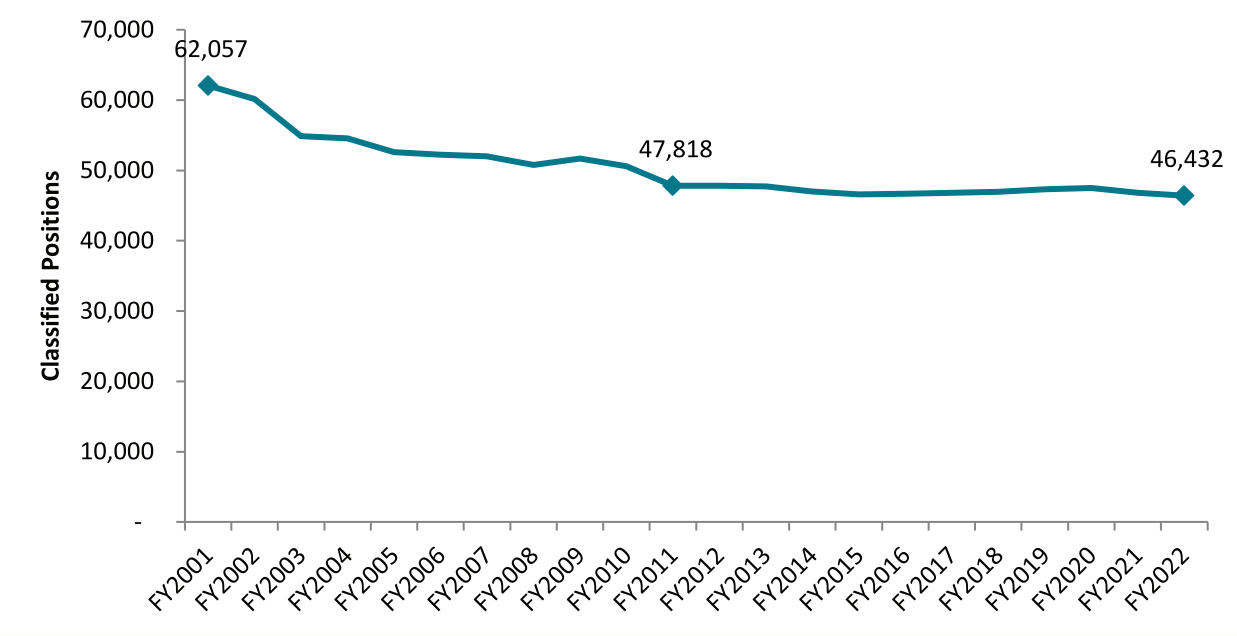
The trends in state education jobs are responsible for driving the positive growth in the overall state government sector since January 2000. In contrast, the loss of K-12 education jobs for much of the last two decades has driven down the overall local government sector. K-12 education jobs are down the most (nearly 27 percent) of all sub-sectors presented here since January 2020. In short, education jobs in each sector moved in opposite directions.

Jobs in local governments not related to education have been below 2000 levels since the economy exited the Great Recession (2007-2009). There were some signs of regaining lost jobs prior to COVID and jobs have been rebounding since.

[38] Citizens Research Council of Michigan. (2013). Michigan's Single-State Recession and its Effects on Public Employment. https://crcmich.org/publications/single_state_recession_effect_public_employment-2013

A further breakdown of the state government sector shows that State of Michigan classified employment is one component that has contributed to the overall decline in non-education jobs (just under a 10 percent decline since January 2000). Annual workforce data from the Michigan Civil Service Commission is presented in Figure 23 and shows average annual classified employment since FY2001. The classified workforce, which comprises all employment categories except education, health services, and hospitals, has shrunk considerably over the past two decades, falling from 62,057 positions in FY2001 to 46,432 positions in FY2022, a 25 percent decline. Most of these job losses occurred during the first decade of the new century, coinciding with the state's "single state recession"; there was a 23 percent decline in state classified positions from FY2001 to FY2011. Since, annual classified employment levels have remained stable.

Figure 23: State of Michigan Classified Workforce, FY2001 to FY2022



Source: Michigan Civil Service Commission

Public sector employment across all levels of Michigan government is smaller today than it was in January 2000. Job losses have been concentrated in the local government sector with non-education state government jobs also experiencing a substantial decline over the past 20-plus years. These losses were due, in large measure, to the financial challenges state and many local governments faced throughout much of the first decade of the new century. Those effects are still evident in today's government employment levels. While public employment was trending up since the Great Recession, the COVID pandemic resulted in another setback to non-education state and local government employment.

Although only a small piece of the state's overall employment base, public sector workers are responsible for delivering a broad menu of key services to taxpayers, everything from safe drinking water to modern infrastructure to public safety and fire protection. These are some of the basic services that current and future residents expect when they are considering whether to make the Mitten State home. As the state considers policies to retain and grow its population, the public sector must be sufficiently staffed and skilled to provide services that will make Michigan a safe, open, and welcoming place.