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NO. 1029 **August 1994**

HOW SCHOOL FINANCE REFORM AFFECTS MUNICIPAL DEVELOPMENT INCENTIVES

One of the goals of the 1993-94 school finance reform efforts was to reduce the overall property tax burden in Michigan. Two unintended consequences of these efforts were the effects on property tax abatements granted to industrial property owners and on tax increment financing engaged in by municipalities. Tax abatements reduce the property taxes levied on specific industrial or commercial properties. Tax increment financing allows municipalities to use a portion of property tax revenue to subsidize economic development.

IN BRIEF

Property owners who were granted or who are applying for tax abatements are at least as well off after school finance reform and amendment of the tax abatement laws as they were under the old provisions of the law.

- The specific tax rate for new industrial facilities abated after December 31, 1993, will be calculated as 50 percent of the rate that otherwise would be levied on that property. These properties will receive the benefits of the reduction in school taxes.
- The specific tax rate for new industrial and commercial facilities abated prior to 1994, will be calculated using the 1993 school operating rate. While these previously abated properties will not receive the benefits of the reduction in school taxes and will be taxed at a rate higher than any newly abated properties, they will be as well off as they are now.

School finance reform reduced property taxes and the amount of revenues available for capture by tax increment finance authorities and limited the ability of these authorities to finance new economic development projects. The long-term effect of these changes will be to diminish these authorities' role.

- Tax increment finance districts with eligible debt may continue to capture revenue from the levy of school operating and other millage to finance their debt. If this revenue proves insufficient for debt financing, state funding will be provided.
- Tax increment finance districts without eligible debt will be able to capture only revenues from the levy of non-school taxes. Since this is a 60 percent reduction in the number of mills from which these authorities may capture revenues, they will be limited as to the scope of new projects.
- Newly created downtown development authorities and local development finance authorities face the possibility of having taxing units exclude the millage they levy from capture. Income cases, it may not be worth creating an authority, given the limited millage that will be available for capture.

Tax Abatements

The state laws relating to industrial facility taxes and commercial facility taxes were amended by Public Act 334 and 340 of 1993. Industrial facility or commercial facility exemption certificates allow local governments to exempt select properties from general ad valorem taxation. Instead, these properties are subject to a specific tax. This exemption may not extend beyond 12 years after the completion of the construction or renovation of a facility. A new provision requires certificate applicants and the granting municipality to enter into an agreement before the state tax commission can approve an exemption certificate. The authority to issue commercial abatements expired on December 31, 1985, but an exemption then in effect continues until expiration of the certificate. Receipts from these specific taxes are distributed among the taxing units in the same manner as the property taxes on which they are based.

Tax abatements have been very commonly used for economic development. As of December 31, 1993, 6,654 certificates were outstanding for abatement of new industrial facilities, accounting for over $15.7 billion of state equalized valuation (SEV). There were 486 certificates outstanding for abatement of rehabilitated industrial facilities, abating about $1.3 billion of investment. While there were 2,620 commercial facility exemption certificates issued of various sorts between 1978 and 1985, worth approximately $600 million of SEV, the number of existing abatements and their current value is unknown.

Industrial and Commercial Facility Taxes

Prior to school finance reform, the calculation of the industrial and commercial facilities' taxes in lieu of general ad valorem property taxes depended solely on the type of facility exempted. These specific taxes represented a 50 percent reduction in tax liability in most cases. While new specific taxes will continue to represent about a 50 percent reduction in tax liability, the specific tax rate of each individual abatement will now vary, depending on the type of facility, when the exemption was issued, and whether the state grants an abatement of its education tax.

Replacement Industrial and Restored Commercial Facility Exemptions. These are granted to businesses investing in pre-existing facilities. Prior to reform, industrial and commercial facility taxes on these facilities were calculated by multiplying the current number of mills levied by all taxing units within which the facility was situated times the SEV of the obsolete property for the tax year immediately preceding the effective date of the exemption certificate. (See Column 1 in **Table 1**.) The increased value of the replacement or restored facility is exempted from taxation for the duration of the abatement.

Because these abatements affect assessed valuation of the property rather than the tax rate, the same method of calculating the specific tax rate will continue to be used. These properties will pay the same general ad valorem property tax rate as other non-homestead properties and will receive the full benefits of the school property tax reduction. (See Column 3 in **Table 1**.)

New Industrial and New and Replacement Commercial Facility Exemptions. These are granted to businesses investing in newly constructed facilities. Prior to reform, industrial and commercial facility taxes applied to these facilities were calculated by multiplying the current SEV of the facility times one-half of the total mills levied by all taxing units in which the facility is situated. The specific tax rate was 50 percent of what is would be if the facility was subject to the general ad valorem property tax. (See Column 2 in **Table 1**.)

The new method of calculating the specific tax rate depends on the timing of the abatement and whether the state treasurer abates the state education tax. If the abatement was granted prior to January 1, 1994, the specific tax rate in 1994 and thereafter includes one-half of the local and intermediate school operating mills levied on that property in 1993 plus one-half of all other, non-school mills currently levied on that property. In other words, presently abated property will continue to pay one-half of the school operating tax rate that was levied in 1993 and will not receive the benefits of the school operating tax reduction. (See Column 4 in **Table 1**.)

If the abatement is granted after December 31, 1993, the specific tax rate in 1994 and thereafter is one-half of the local millage levied on non-homestead property for that year plus whatever the state treasurer abates from the six-mill, state education tax. The state treasurer may abate all, 50 percent, or none of this tax if doing so is "necessary to reduce unemployment, promote economic growth, and increase capital investment in this state." (See Column 5 in **Table 1**.) The net result is that industrial facilities abated in 1994 and thereafter will pay a lower rate than those abated prior to 1994.

Table 1

INDUSTRIAL FACILITIES TAX RATE FOR NEW FACILITIES
(Buildings, Machinery and Equipment)
EXEMPTED PRIOR TO AND AFTER DECEMBER 31, 1993

	----- Before Reform -----		------------ After Reform ------------		
Taxing Jurisdiction	**Ad Valorem Millage**	**Ind Facility Tax Rate**	**Ad Valorem Millage**	**Ind Facility Tax Rate Pre 12/93**	**Ind Facility Tax Rate Post 12/93**
	(1)	(2)	(3)	(4)	(5)
STATEWIDE AVERAGE					
State Education Tax	N/A	N/A	6.0	N/A	0-3-6**
Local School Operating	34.0	17.0	18.0*	17.0	9.0*
All Other Millage	24.0	12.0	24.0	12.0	12.0
Total Millage	58.0	29.0	48.0	29.0	24.0**
DETROIT					
State Education Tax	N/A	N/A	6.0	N/A	0-3-6**
Local School Operating	41.1	20.5	18.0*	20.5	9.0*
All Other Millage	49.4	24.7	49.4	24.7	24.7
Total Millage	90.5	45.3	73.4	45.3	36.7**

* School Operating Mills do not include enhancement or hold harmless millage.

** The state treasurer can abate all, 50 percent, or none of the six-mill state education tax, causing school taxes to be three mills higher or lower than the example, which assumes a 50 percent abatement.

Tax Increment Financing Programs

Tax increment financing programs, which now include downtown development authorities (DDAs), tax increment finance authorities (TIFAs), and local development finance authorities (LDFAs), have been available to local units of government since 1974 as a tool for economic development. (For purposes of this paper, "authorities" or "tax increment financing authorities" are meant to broadly include downtown development, tax increment finance, and local development finance authorities.) The fact that there are three types of these authorities is indicative of changing municipal needs over time. Each type of authority has a similar basic mission, structure, powers, and revenue sources. Each is a public body, created by the governing body of a local unit, controlled by a board of directors which is appointed by the elected officials of the municipality, and having jurisdiction for limited purposes over a district(s) within the municipality. The principal differences between these three authorities are what type of local unit may create them, which areas of the municipality may be included within the district, and what property contributes to the tax increment revenues.

The use of tax increment financing as an economic development tool has been fairly popular in Michigan. As of June 30, 1993, some 276 DDAs, 85 TIFAs, and 67 LDFAs had been created by 322 cities, villages, and townships, 91 of which have created more than one authority. Municipalities with established economic bases have been the most common users of these authorities.

Tax Increment Financing as a Revenue Source

The statutes which authorized tax increment financing permitted these authorities to capture the revenues from the levy by all local governments of non-debt (and in some cases, debt) property taxes on the increase of state equalized value in the district or development area over the base year in which the tax increment financing plan was approved. Tax increment financing is the major revenue source and is the most important aspect of these authorities: all other functions and powers are also functions and powers of local governments. Only through tax increment financing can the increase in property tax revenues resulting from economic development be directly funneled back into the creation of incentives for additional economic development. The ability to capture tax increment revenues was the only function of these authorities affected by the Proposal A related legislation.

Tax increment revenues are pledged to repay the principal and interest on bonds issued by the authorities as well as used to pay their operating expenses and project costs. While these bonds are not considered a debt of the local unit, in most cases the local units pledge their full faith and credit from existing revenue sources to support the bonds (limited tax obligations). As of December 31, 1993, over $800 million of tax increment finance bonds were outstanding with an annual debt service requirement of $60 million for principal and interest. In addition, there are some non-bonded debt requirements that these authorities (or the creating municipalities) are obligated to pay.

In the past, revenue from the levy of school operating property taxes comprised anywhere from 55 to 80 percent of the revenue of tax increment financing authorities. The capture of this revenue to fund economic development instead of education has been and issue in the past. Because of its capture, out-of-formula districts had to operate with less revenues while the state reimbursed in-formula districts for their lost school revenues. The reduction in school operating millage resulting from the adoption of Proposal A created a problem for tax increment finance authorities to meet their outstanding obligations.

Tax Increment Financing Under Proposal A

Amendments to the tax increment financing acts (Public Acts 280, 281, and 282 of 1994) appear to have found some compromise between financing economic development and the intent to use school millage exclusively for education. Revenues from school operating millages may be captured now only to the extent needed to finance debt that existed prior to the beginning of the school finance reform process and certain "other protected" debt.

To qualify as existing debt, it must fall into one of three new categories. (1) "Eligible obligations" include most contracts, agreements, leases, subleases, bonds, notes or requirements to pay imposed by law issued or incurred or incurred before August 19, 1993. (2) "Eligible advances" are transfers made before August 19, 1993 to an authority by a municipality in anticipation of repayment by the authority. (3) "Other protected obligation" is broadly defined to provide a window of opportunity for authorities to finance new projects that were described in a development plan before August 19, 1993, but not yet begun. Authorities with debts that fall into these categories may capture revenue from school operating taxes only to the extent needed to finance this debt.

In existing authorities with eligible advances or obligations, if captured school revenues prove insufficient to finance the outstanding debt, captured revenues from non-school millage will be used to supplement the captured school revenues. (See Column 2 in Table 2.) If eligible obligations or advances still remain after all available millage has been captured, the state is required to reimburse the authority up to the amount that would have been captured if 1993 school millage were still being levied. If debt financing does not require all of the revenues from captured, non-school millage, it can be used for current operations and for new economic development projects.

Existing authorities without any outstanding eligible obligations may capture only non-school tax revenues. Authorities created in the future will be limited to the capture of non-school tax revenues, and other taxing units will have the option of excluding their millage from capture. (See Column 3 in **Table 2**.) A taxing unit with millage that would otherwise be subject to capture may exempt its taxes from capture within 60 days of the public hearing held to create a new downtown development or local development finance authority or to increase the size of either district.

Table 2

MILLAGE AVAILABLE FOR CAPTURE FOR TAX INCREMENT FINANCING

Taxing Jurisdiction	Before Reform All Authorities	After School-Finance Reform All Protected Obligations	 Non-Protected Obligations
SCHOOL MILLAGES	(1)	(2)	(3)
Local School Millage	Yes	Yes	No
Enhancement Millage	N/A	Yes	No
Hold Harmless	N/A	Yes	No
Sinking Fund	Yes	Yes	No
Intermediate School Millage	Yes	Yes	No
State Education Tax	N/A	Yes	No
NON-SCHOOL MILLAGES			
Unit Creating Authority	Yes	Yes	Yes
Overlapping Taxing Units	Yes	Yes	Yes, but may opt out of new districts

MILLAGE AVAILABLE FOR CAPTURE FOR TAX INCREMENT FINANCING