CRC MEMORANDUM

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Reforming Statutory State Revenue Sharing

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The State of Michigan runs a program that is somewhat unique – distributing a portion of state-collected tax revenues to local governments for their unrestricted use. The restricted revenue sharing programs operated in Michigan – sending state-collected funds to local governments to fund programs such as education, highway construction and maintenance, court funding, liquor enforcement, and mental health care, etc. – can be found in most states. Programs in which the state collects taxes and sends the revenues to local governments for them to use at their discretion are not as common.

Michigan's unrestricted state revenue sharing program is now 75 years old. For the first 30 years of its history, it served solely to send funding to all local governments. That purpose is currently served by the constitutional revenue sharing program that shares funding with local governments through a per capita distribution. Since 1971, the state has attempted to give revenue sharing greater purpose by directing funding in the statutory revenue sharing program to local governments with the greatest needs – defined at various times as the demand for expanded menus of services and the lack of capacity to fund services from locally-collected revenue sources.

The last effort to define the goals of the statutory unrestricted state revenue sharing program – to supplement the revenue raising capabilities of local governments with less property tax capacity – were never fully implemented. Only about one-quarter of the local governments eligible for funding continue to receive statutory state revenue sharing funding today, and the methodology for determining the levels of funding distributed to each of those governments has more to do with the levels of funding in prior years than any measure of current needs.

Unequal Fiscal Capacity of Local Governments

Understanding the varying levels of fiscal capacity – the varying ability to finance public services and the varying demand to provide public services – across local governments is key to understanding the insufficiency of leaving governments to their own devices or attempting to address needs with a per capita distribution of state funds. First, variances in tax bases means that the challenge of raising revenues is not uniform across local government.

Additionally, the services provided and the intensity of service provision depends on a number of factors. Most significantly, the need for an active local government increases when large numbers of people live, work, and interact in small geographic areas. It is not practical to measure needs by assessing the demand for individual services on a unit by unit basis, but it is possible and common to assess needs based on "pseudo" measures of needs by using population density and housing density to identify jurisdictions in which the conditions suggest more demands will be placed on the local governments.

Taxable Value. Michigan local governments are highly dependent on property taxes to raise the necessary revenue to provide services. On average, Michigan communities have about $31,000 per person of taxable value upon which taxes can be levied to yield

property tax revenue. Tax yield is a result of a tax rate applied to the tax base. One mill (a dollar of tax for every $1,000 of taxable value) levied in the City of Saginaw, therefore, will yield only about a third of the amount per capita that the same mill would yield in a community with the average tax base. On the other hand, communities with above average tax bases do not have to tax themselves at a full mill to yield what communities with average tax bases would yield.

Population Density. Local governments that serve large numbers of people located in close proximity to one another are called upon to provide more services and services at higher intensity levels than local governments that serve sparsely populated areas. In densely populated places:

- People's actions are more likely to affect other people.
- More ordinances are adopted to control what residents can do.
- Planning and zoning actions are more significant.
- Fire protection is needed not only to address a structure that is on fire, but to prevent damage from spreading to other structures nearby.
- Public transit is important to mitigate congestion.
- Higher traffic levels require an intensified police role to manage the interaction between drivers.

Housing Density. The demand for local government services also varies based on the number and density of houses and other buildings in the jurisdiction.

Combinations of Tax Base and Service Demands. The financial ideal for local governments is found when they have large tax bases to serve sparsely populated communities. Large tax bases would help them to generate needed revenues at low rates. Sparsely populated communities would have less demand for local government services.

Chart 1 and **Figure 1** shows that only about 11 percent of the local governments enjoy having high taxable value per capita and low population density. Chart 1 plots each local government's taxable value per capita against its population density. The vertical blue line represents the average population density of 175 people per square mile. The horizontal line represents the average tax base, with $31,911 of taxable value per capita. Each quadrant in the chart is labeled (1 through 4).

Quadrant 1 (upper left) is the ideal with high taxable value per capita and low population density. Quadrant 2 (upper right) is a favorable situation with high taxable value per capita used to serve populations with above average density. Local governments in Quadrant 3 (lower left) should be able to manage. They have below average tax bases, but their below average population densities means that they are called upon to provide few services. Quadrant 4 is to be avoided. These local governments have below average tax bases on a per capita basis, but their above average population densities means that they have higher service demands. More than a quarter of the local governments are found in this quadrant, but they serve half of the state's population.

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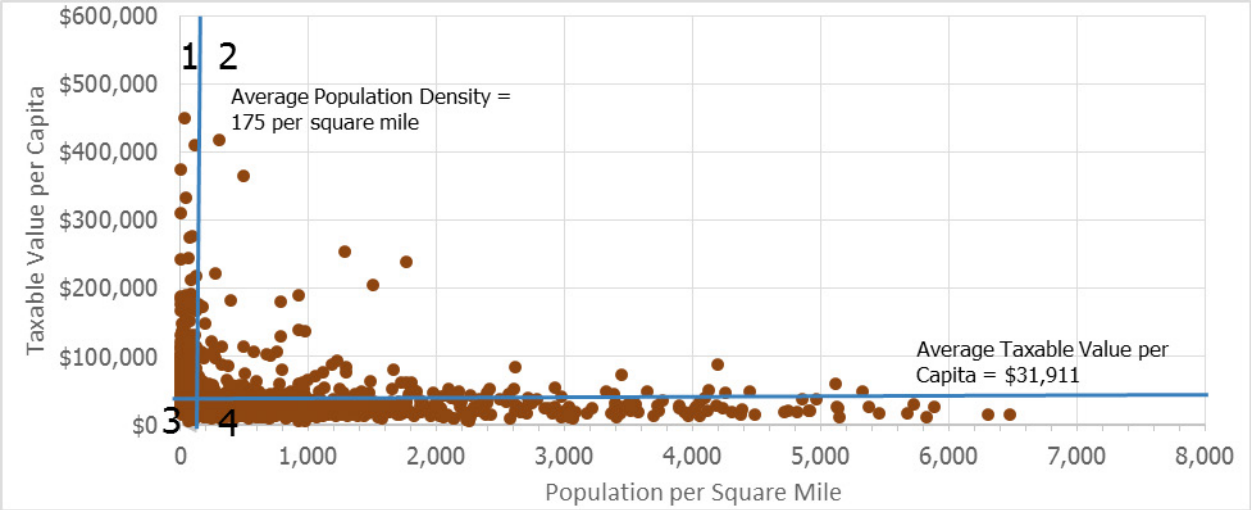
Chart 1
2012 Taxable Value per Capita and 2010 Population Density of Michigan Local Governments



Note: For purposes of scale, two outliers were removed. Pointe Aux Barques Township in Huron County with taxable value per capita of $1,423,511 and a population density of 7 people per square mile was removed from the vertical axis and the City of Hamtramck in Wayne County with a taxable value per capital of $8,828 and a population density of 10,751 people per square mile was removed from the horizontal axis.

Sources: Michigan Department of Treasury, U.S. Census Bureau.

Figure 1
Units & Populations in Each Quadrant:

1. Units with Below Average Density & Above Average Taxable Value per Capita (upper left): 604
   Number of Units as Percent of all Local Governments: 34%
   Population: 1,056,921
   Population as Percent of State: 11%

2. Units with Above Average Density & Above Average Taxable Value per Capita (upper right): 235
   Number of Units as Percent of all Local Governments: 13%
   Population: 3,030,165
   Population as Percent of State: 31%

3. Units with Below Average Density & Below Average Taxable Value per Capita (lower left): 446
   Number of Units as Percent of all Local Governments: 25%
   Population: 1,140,657
   Population as Percent of State: 12%

4. Units with Above Average Density & Below Average Taxable Value per Capita (lower right): 488
   Number of Units as Percent of all Local Governments: 28%
   Population: 4,918,292
   Population as Percent of State: 50%

History of State Revenue Sharing

Michigan's state revenue sharing program was created in a series of policy actions spread over 60 years. In many ways it is constructive to think about the overall program in two parts: constitutional revenue sharing and statutory revenue sharing. Constitutional revenue sharing is the result of a 1946 amendment to the state Constitution that dedicated revenues to local governments and schools. The dedication of revenues from the intangibles, income, and single business taxes eventually came to be known as statutory revenue sharing. In the late 1990s, these individual dedications were melded into a single dedication of additional funding from sales tax revenues (beyond the constitutional dedication). The significance of constitutional and statutory state revenue sharing has grown as Michigan's systems of state and local government finance have evolved.

People at various times may interchangeably term the program state aid instead of state revenue sharing. State aid would imply that state policymakers at some point decided that state revenues were sufficiently plentiful that they could be put to good use helping the finances of local governments. Such an implication would assume that local governments were in need of assistance and since each revenue sharing distribution was designed to distribute revenues to all units of local government, that all local governments were in need of assistance.

In fact, the program is termed state revenue sharing because state policymakers agreed to serve in a revenue raising capacity to capitalize on revenue raising efficiencies and share state-collected revenue with local governments, usually because the finances of local governments were negatively affected by statutory changes that exempted parts of the property tax base from taxation. Historically, the state has adopted policies to distribute revenues to local governments for two purposes: 1) the replacement of revenue after certain local taxes were either discontinued or preempted by the state; and 2) to supplement local government revenues and general funds.

Reforming Michigan's State Revenue Sharing Distribution

Part of the need for this report rests with the fact that the goals of statutory state revenue sharing have not been clearly delineated in the past. State policymakers may just see a pot of money being distributed to local governments without a common understanding of the goals behind it. The loss of institutional knowledge inherent in the system because of term limits for state officials further lessens connections to past policy decisions.

Thus, it is of fundamental importance that state policymakers define a goal for state revenue sharing. Michigan has had different goals that drove the distribution of state revenue sharing over the years, but none of those goals are applicable to the distributions in the current program, which have been revised and changed yet again over the years without a focus on the overarching goal of the program. Given the current scarcity of resources at the state level and the challenges confronting many of Michigan's local governments, that goal should be to send funding to those governments with the greatest needs.

A necessary first step in defining need and setting goals for state revenue sharing is establishing a common understanding of the purpose of local government. For the Citizens Research Council of Michigan, the purpose of local government is to manage the interaction between people. People can exist in nature without government, but when people aggregate into communities, there begins to develop a demand for public services. People seek public safety to protect against injury to their person or property. They seek planning and zoning to protect against negative externalities such as noise or air pollution. They seek parks, recreation services and other quality of life amenities.

Having established the purpose of local government, a necessary next step is to establish the state's interest in local government. The common denominator for systems that attempt to recognize needs is an interest in equalizing the fiscal capacity of the local governments so that citizens are not deprived of basic governmental services simply because of the jurisdiction within which they live or work.

Fundamentally, need is defined either in terms of the capacity of a government to raise revenues or in terms of the demands placed on a government to provide services. Revenue sharing distribution programs that are designed to address fiscal capacity attempt to help local governments that are less capable of helping themselves.

Options for Reform

The options for reform that follow are divided into

- those that account for inequities in local government tax bases,
- those that are based on differences in service needs,
- those that recognize key places that contribute to the state's economy, and
- those that fund the local government services most valued by the state.

Equalize Tax Bases

Taxable Value per Capita. This formula divides the state average taxable value per capita by each local government's taxable value per capita and the result is multiplied by the unit's population to obtain the unit's weighted population.

Tax Yield Equalization. Rather than measuring the adequacy of each government's tax base on a per capita basis, this measure assessed the productivity of one mill of taxation in yielding revenues. Local governments for whom a mill of taxation does not generate revenues at the state average receive funding. Those for whom one mill generate revenue in excess of the state average receive nothing.

Evaluation of Tax Base Factors. The primary difference between taxable value per capita and tax yield equalization is that the first measure is more heavily predicated on the idea that local government services are provided to people, while the second measure is indifferent to whether the services are provided to people or properties. Certainly, much of the services provided to local governments are provided to people, but things like garbage collection, fire protection, planning and zoning, and others are less dependent on the number of people in the community.

Tax Exempt Properties. The state revenue sharing program could compensate local governments for hosting tax exempt properties as part of an effort to assist local governments less able to raise revenues from own-source revenues. Two options would be to fund each parcel of tax exempted property at flat amounts or fund each parcel of tax exempted property according to the amount of square footage or acreage encompassed by those properties.

Demand for Services

Alternative methods of revenue distribution are based on assessments of the services provided. These assessments are best if they are based on measures of units served – people or properties – or measures of services provided – crimes responded to, fires put out, park acreage, etc. They should not be based on the cost of serving people or property, or the cost of providing specific services. To do so, creates perverse incentives for local governments to inflate costs to enhance payments from the state.

On a macro level, there are no services universally provided by all cities, villages, and townships throughout Michigan. Many functions – property assessing, tax collection, accounting, planning and zoning, etc. – are nearly universally performed by local governments. However, these are fundamental responsibilities of local governments, the cost of which should be borne locally. Not all cities, villages, and townships in Michigan provide police and/or fire protection, provide parks and recreation, collect refuse, or engage in other activities commonly associated with local governments.

Because of the difficulty in weighing one unit of local government's needs against another's and because of the lack of uniformity in services provided, governments tend to use "pseudo" measures that are commonly accepted as indicators of heightened demand for services.

Nighttime Populations. Michigan, and most other states, have historically used data compiled by the U.S. Department of Commerce's Census Bureau for the distribution of constitutional revenue sharing. However, this approach for state revenue sharing (beyond the per capita constitutional revenue sharing distributions) has several shortcomings. Since the census counts people in their residence, it is essentially only counting the nighttime population of each community.

Daytime Populations. A revenue distribution methodology based on a measure of daytime populations would better reflect where interaction between people occurs. Many local governments have daytime or seasonal populations that are remarkably different than their census, or nighttime, populations. Communities that host office buildings, commercial centers of commerce, and industry tend to have larger daytime populations than their census populations would indicate. Conversely, Michigan's bedroom communities tend to empty out during daylight hours when residents commute to places of employment or commerce.

While the daytime and seasonal populations are preferable to census or nighttime populations as pseudo measures of need, this measure is still less than desirable for several reasons. Most significantly, like the nighttime population, this measure does not account for differences in density.

The greatest obstacle to using daytime populations as a factor in distribution calculations is the lack of reliable data. The problem is that there is not a third party that counts the number of people that come to these places. Each tourist attraction, shopping mall, etc. can have incentives to overestimate their popularity, and there are no means to audit or validate the populations that they may report.

Population Density. Population density is an alternative to the use of the census population. This is simply a measure of the average number of people living within each square mile of land area in a community. Since the population density of different communities is highly correlated with the number and intensity of services that the communities provide, this measure better reflects the demand for governmental services.

Building Counts and Building Density. In addition to services provided to people, local governments provide a number of services to properties. Fire protection, refuse collection, storm sewers, and snow removal are examples of services for which the intensity and cost of services depends to a greater extent on the number of buildings than the number of people being served.

Unit Type. Historically, residents of a community have chosen a level of incorporation – city, village, or township – for their local government to reflect the level of services they expect from that unit. The 1998 reforms to the state revenue sharing distribution formula included a measure of the unit type that was based on the contention that service delivery costs are a function of the type of unit and population size within a given unit type.

Evaluation of Service Demand Factors. Population density, building density, and/or unit type could be used, individually or in combination, to reflect the greater service demands on some local governments as opposed to others. They could be used to create weights that would be applied to the local government's population, as measured by the decennial census or the American Community Survey.

Funding Certain Key Places

Part of the state's exercise in defining its relationship with local governments and the goals it hopes to achieve through a revenue sharing program might include an assessment of whether some places are of extra significance to the state. Of course, the state has an interest in all local governments operating at their respective peak, but it has a stronger interest in some local governments. This strategy would direct state resources to those places for which the state has the strongest interest to the exclusion of other places or public services.

Agricultural communities, while important to the state economy, do not require a great deal of local government services. Forestry is a very important part of the state economy as well, but again it requires little by way of local government services. The idea here is that Michigan's core cities, commerce centers, manufacturing hubs, and tourist destinations, require a higher level of intensity in local government service delivery. Therefore since such places contribute significantly to the state economy and are important to outsiders' perceptions of the state, servicing these locations ought to be a priority.

Directly Fund Key Services

State policymakers could also drop the pretense of providing this funding for unrestricted use by local

governments. Funding would be restricted to specific public services related to the health and safety of residents – police protection, fire protection, emergency medical services (EMS), courts, county health programs, and water and sewer quality services. This would bend the rules for state revenue sharing in many ways. Such a program would have to meld the revenue sharing programs that direct funding to cities, villages and townships with that which provides funding to counties. This approach would direct funding to the services without regard to the entity responsible for providing that service in different areas of the state.

Pros and cons are associated with such an approach. By tying the funding to specific programs, it might make it harder for future legislatures to redirect funding for state purposes as has often occurred throughout the history of state revenue sharing.

Alternatively, funding is fungible. The addition of funds for a specific service may simply free up existing local funds dedicated to that service to be redirected for other services. While on its face this might appear as a move away from unrestricted state revenue sharing, in the end it may provide the same freedom of spending as the current program.

Such a program would require assembly of multiple measures of services provided by the state's public safety entities. A police measure could use data reported to the state and the Federal Bureau of Investigation of crimes reported and cases cleared. A fire measure could be comprised of the number of fires and emergencies occurring within each department or authority's geography. Similar measures could be assembled for emergency medical services.

Recommendations and Alternatives

There are no clear answers to the matter of reforming Michigan's statutory state revenue sharing program. Accordingly, recommendations are focused on decision points for state policymakers. The alternatives offered below offer distribution methods that would get funding to Michigan's communities most in need in terms of their abilities to raise revenues or their service delivery demands.

Recommendations

The first recommendation is for state policymakers to decide if the statutory state revenue sharing program is a priority. If it is, its importance must be emphasized by a return to funding at the levels designated in statutory law. FY2014 funding levels equate to roughly a 75 percent cut in funding from the statutory base. After funding is sent to Detroit, which is arguably inadequate to meet the city's needs, there is not sufficient funds available to meet the needs of other local governments. If it is not the priority it once was, they should end the illusion and direct the funding to meet other needs.

If revenue sharing is a priority, then the second recommendation is for state policymakers to examine the purpose of local government and the role they see statutory state revenue sharing helping to serve that purpose. This analysis was done based on the idea that local governments exists to manage the interaction between people. This need not be the only role local governments are deemed to fill.

Based on CRC's understanding of this purpose, it therefore makes sense that the role of statutory state revenue sharing is to ensure that all local governments are equipped to perform this purpose at a minimum level. This can be done by directing funding to affect differences in fiscal capacity or by directing funding to the places or services that the state values.

Alternatives

CRC suggests the consideration of either of the following two approaches to achieving this aim:

1. A formula that considers both the capacity of a government to raise revenues and the demands placed on a government to provide services.

2. A program that moves away from the unrestricted nature of state revenue sharing to fund public safety programs.

A New Formula to Address Fiscal Capacity

A new formula to address fiscal capacity should recognize both that some local governments do not have the sufficient tax base to productively raise funding to support their own operations with local taxation, and that some local governments are called upon to provide services at higher levels. Keeping in mind the need to keep a new formula simple and understandable, a new formula should be broken into parts based on different factors that recognize that the needs of Michigan's local governments are not easily defined by one measure of need.

Insufficient Revenue Raising Capacity

Given Michigan's heavy reliance on property taxes as the primary source of local taxation for cities, villages, and townships, the options that could be used to assess revenue raising capacity are few. The distribution of funding to equalize tax yields or on a tax base per capita basis both achieve the same goal. However as described above, wherein tax yield equalization operates independent of population, making it better suited to meeting the needs of Michigan's urban places at this time.

Heavier Service Demands

The second part of a fiscal capacity formula should recognize the heavier demands for services placed on some local governments. Because local government services are provided both to people and to properties, service demands should be measured as population density and building density. These measures recognize that the closer people are to one another, and by extension the closer their residences are to one another, the more they'll interact. This will result in a greater demand for public safety services, a greater demand for services such as garbage collection or planning and zoning, and increased interest in quality of life services such as parks, libraries, and recreation facilities and programs.

Transition to Restricted State Revenue Sharing

The present scenario, with state policymakers considering policy actions to rebuild the statutory state revenue sharing program and many local governments presently receiving no funding from this program, offers an opportunity to rethink the unrestricted nature of the funding that flows to local governments. Rather than distributing the funds to local governments with the understanding that public safety is the function that consumes the most local dollars, such a change would direct state funding directly for these purposes – police, fire, and emergency medical services.

Rather than using the pseudo measures of need, as is necessary in the unrestricted state revenue sharing distribution formulas, a restricted revenue sharing program for public safety should be based on actual measures of activities that drive the staffing and cost of public safety agencies.

Conclusion

An economic, efficient use of taxpayer dollars suggests that the government responsible for providing services should also be the government responsible for collecting the taxes. Despite this bedrock principle of good government, reasons to continue and reconstitute statutory state revenue sharing are plentiful. On top of the fact that Michigan's history of sharing revenues has created a dependence from which local governments will not easily be weaned, state revenue sharing also serves to diversify the revenue structure of local governments; to facilitate economic development by diminishing the need for local taxes to be levied at exorbitant and non-uniform rates; and to ensure that a minimal level of services are provided across all jurisdictions.

The circumstances of the past decade have left Michigan with a state revenue sharing program that bears little resemblance to its prior self. There is little rhyme or reason to the methodologies used to distribute statutory state revenue sharing to local governments, nor to the amounts that they receive.

This report identifies opportunities for addressing that weakness, either in a continued unrestricted state revenue sharing formula or as a new restricted revenue sharing program for public safety. The effective use of public resources in such a program depends not only on a sound formula for getting funding to the governments with the greatest needs, but also on a level of funding sufficient to make a difference.

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