MICHIGAN SCHOOL FUNDING/TAX POLICY

WHY PROPOSAL "A" DIDN'T FIX SCHOOL FUNDING
June 24, 2009

Introduction

The 1994-95 fiscal year witnesses a dramatic change in the way that Michigan's public elementary and secondary schools are funded.

In July 1993, the Legislature eliminated local school property taxes, reducing by nearly $7 billion the annual funding for Michigan's public schools beginning in the 1994-95 school year.

On December 24, 1993, the Legislature passed legislation to establish a new method for distributing State school aid through a foundation grant system, and produced two solutions to school finance reform, one a statutory plan and the other a ballot proposal for a change in the Constitution. The Legislature opted to let the people of Michigan decide between the two revenue proposals for the funding of public schools.

Voters were presented the constitutional amendment on school finance, Proposal A, in a March 1994 special election. The ballot proposal called for amending the Constitution to increase the sales tax, limit future assessment increases, and allow different classes of property to be taxed at different rates for school operating purposes. Approval of the amendment also would trigger a package of related tax changes including a six-mill State education property tax for school operations and an income tax rate decrease from 4.6% to 4.4%. Rejection of the ballot proposal automatically would make effective the alternative plan referred to as the Statutory Plan. The new school aid system for distributing State payments to school districts through a per-pupil foundation allowance would be the same under either plan.

The following chart taken from a Senate Fiscal Agency Publication entitled School Finance in Michigan Before and after the Implementation of Proposal A, December 1995 illustrates the changes caused by Proposal A.

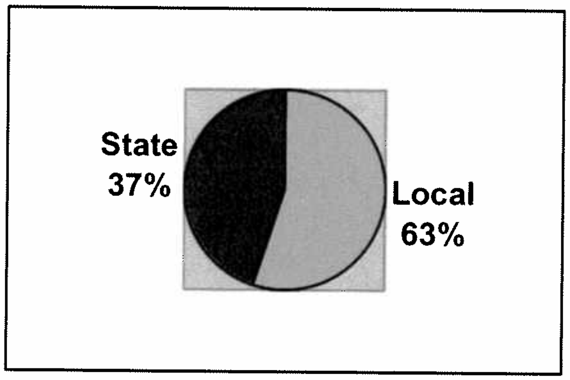
REVENUE SOURCES EARMARKED TO THE SCHOOL AID FUND		
Revenue Source	**Before Proposal A**	**After Proposal A***
Sales Tax**	60% of proceeds at a 4% rate	60% of proceeds at a 4% rate and 100% of revenue from the 2% increase
Use Tax		All revenue from the 2% increase
State Education Property Tax		All revenue from statewide 6-mill property tax
Real Estate Transfer Tax		All revenue from 0.75% tax
Income Tax		14.4% of gross collections after refunds at a tax rate of 4.4%
Cigarette Tax	Two cents of the 25 cents per pack tax	63.4% of proceeds from the 75 cents per pack tax
Other Tobacco Products		All proceeds of the tax (16% of the wholesale price) on cigars, noncigarette smoking tobacco, and smokeless tobacco
Lottery	Net Revenue	Net Revenue
Industrial and Commercial Facilities Tax	Paid to the SAF for properties in school districts receiving State equalization aid (in-formula districts)	The school district share goes to the SAF except for the amount (if any) attributable to "hold harmless" millage levied by the school district.
Commercial Forest	Paid to the SAF for properties in school districts receiving State equalization aid (in-formula districts)	The school district share goes to the SAF except for the amount (if any) attributable to "hold harmless" millage levied by the school district.
Liquor Excise Tax	Revenue from 4% excise tax	Revenue from 4% excise tax

* The effective date of the earmarking changes varies by tax. For new taxes such as the State education tax and the real estate transfer tax, the earmarking begins on the effective date of the tax. The income tax earmarking begins October 1, 1994. The sales, use, cigarette, and other tobacco products tax rates and earmarking changes were effective May 1, 1994.

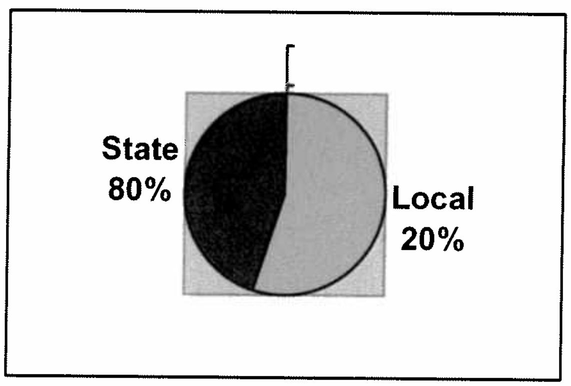
** Constitutionally dedicated to the School Aid Fund.

The theory of Proposal "A" was to relieve the burden of local property taxes while eliminating the disparity in funding from school district to school district. It also assumed a reasonable rate of growth to provide for increasing costs for school districts over time. During the first few years there were gains made in narrowing the expenditure gap between higher and lower funded districts. Because funding flowed from the State, differences in local tax bases were offset by all areas sharing in the proceeds from property taxes on business and high density, high value residential property, thus giving less wealthy areas a larger funding base than the local property value had allowed. Additionally, the blend of the major tax components in the proposal (property tax, sales tax, use tax and income tax) were supposed to add stability to the funding stream and provide some insulation from shifting economic tides. The dramatic shift in school funding sources is illustrated by the charts below. The relationship between state and local funding reversed itself with the passage of Proposal A.

Local State Funding Mix 1994



Local State Funding Mix 1995



As anticipated, Proposal A did help to relieve local property tax burdens on both business and individuals. In the beginning, it also provided critical resources to school districts who had traditionally struggled to get adequate funding under the prior system. This boon did not last.

Proposal A: Are We Better Off?

In June of 2004, the Senate Fiscal Agency published an issue paper which analyzed the first ten years of Proposal A. Some of the findings in that publication follows:

> The analysis of how school districts have fared under Proposal A and the attempt to answer the question, "Would districts be better off without Proposal A?" is based on several key assumptions. The major assumptions are highlighted here. The analysis produces a hypothetical operating revenue scenario in the current year *if* Proposal A had not been adopted, and compares that level of revenue, by each school district, with its actual payments in the current year. First, school aid payments to districts were inflated from the 1993-94 levels (the year immediately before Proposal A was implemented) by the estimated percentage growth rate in what the SAF revenue would have been had the Fund *not* experienced any of the revenue changes mentioned above (e.g., sales tax is assumed to have remained at 4%), adjusted slightly for an assumption in General Fund (GF) contributions to the K-12 budget. The growth in the earmarked revenue to the SAF from 1993-94 through 2003-04 without Proposal A changes is estimated at 48%. Separately, the General Fund contribution to K-12 in 1993-94 was $716.6 million, or 9% of entire GF revenue. Assuming that the GF contribution to the SAF would remain at 9% today, if Proposal A had not occurred, yields a $793 million contribution. Combining these assumptions of SAF revenue growth and GF contribution to the K-12 budget produces a 40% increase to apply to each district's 1993-94 State Aid payments to determine an estimated 2003-04 State Aid payment. Second, since SEV data are no longer collected at the school district level but are collected at the local unit of government level, district 1993-94 SEV data were inflated by the same percentage increase in SEV experienced by the local unit that collected the data, over the 10-year period. This yields an estimate for each district's 2003-04 SEV, which is needed for an analysis of hypothetical local revenue to be generated today, if Proposal A had not occurred. Third, mills levied in 1993-94 are assumed to be at the same level in 2003-04. This assumption is made for two reasons: 1) It is impossible to predict if, when, and by how much voters would have been willing to adopt millage increases; and 2) Headlee rollbacks are not assumed in the analysis. Excluding Headlee rollbacks of millage rates from the analysis provides some leeway for offsetting millage increases that may have occurred.
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> Given the assumptions listed above, the analysis concludes that out of 553 school districts, 28 are "better off" with Proposal A and 525 are "worse off" in terms of combined State and local revenue. Essentially, this means that comparing actual 2003-04 State Aid payments plus districts' actual 2003-04 local property tax revenue with estimated State payments and local revenue if Proposal A had not

happened, yields less money for 95% of the districts. The 28 districts that are "better off" with Proposal A had either relatively small growth in SEV over the last 10 years, or large growth in their per-pupil foundation allowances. Further, 24 of the 28 had gains in enrollment. It would seem that enrollment has played a larger part in determining how a district's revenue has fared under Proposal A than the growth in the foundation allowance.

Proposal A changed the way schools are funded from a property tax revenue structure to a *perpupil* basis. Therefore, all else being equal, a district that sees reduced pupils will see less funds as well. The reader may ask, "Could declining enrollment itself cause a district to receive less revenue under Proposal A than if Proposal A had not occurred?" Even assuming the same pupils as in 1993-94, the vast majority of districts would have had more operational revenue without Proposal A. Again, this analysis rests upon an assumption that mills would be the same today as in 1993, which would have placed on school districts the burden of petitioning for continued high millage rates as SEV grew over time.

The quick answer to why most districts would see increased revenue had Proposal A not occurred is that, Statewide, SEV more than doubled over the past 10 years, but SEV is no longer the basis for school district operating revenue. One of Proposal A's primary objectives was to lower property taxes, and this was accomplished by both lowering mills and capping the assessment growth rate. If no changes had occurred, property owners would be paying over $12.6 billion today for school operations, more than triple what is actually being collected.

While most school districts fare more poorly under Proposal A than if no change in the funding of schools had occurred, property owners have reaped the benefits of smaller property tax bills for school district operations, which have contributed to housing accessibility and the boom in Michigan's real estate market. One downside to pre-Proposal A funding for school districts was the reliance on the often unpredictable nature of millage elections to determine the districts operating revenue and budgets; now, that dependence has been virtually eliminated and a more stable source of revenue exists.

Given the political pressure from the high levels of property taxes in 1993 that led to Proposal A, it is unlikely that some change would not have happened over the last 10 years given the strong growth in SEV, which would have driven property taxes even higher. Also, declining revenue over the last four years has placed increasing pressure on the General Fund grant to the K-12 budget. Certainly, it is questionable whether the level of GF commitment to the education budget could have continued at the 1993-94 level if Proposal A had not occurred and the budget still relied heavily on this funding source. With a finite amount of resources, one segment "wins" while another "loses". In this case, home owners win big with respect to lower tax bills for school operations (and owners of business property or second homes also see lower tax bills, although not generally of the magnitude that primary home owners experience). School districts, on the other hand, receive less operating revenue under the current system. The answer to the question, "Are we better off with Proposal A?" unmistakably reflects who "we" are defined to be.

Did the Makers of Proposal A Plan to Give Schools Less Support?

It does not seem reasonable to assume that the sitting Legislators in 1993 intended for ninety five percent of the schools to get less support than they had in 1993 ten years after the passage of Proposal A. That leads to the question "How did it Happen"? With the State providing majority support, school revenue was subject to the whims of decision makers at the state level, versus local voters. Proposal A funding had barely been put into affect before the State began to make changes in the tax structure. Even though the categories of taxes and levels of taxation where enshrined in the Constitution, a series of tax policy changes caused a drastic erosion of the tax base for funding schools. Many of the tax policy changes were made in the name of increasing the Michigan economy by creating a better business climate. Some that were made in the economic boom of the 1990s may have been made simply to slow down the growth in tax revenue. No matter what the motivation, the result by 2004, and certainly continuing through today is that most schools would have been better off under the prior system of funding. It should also be noted that the preponderance of the changes in tax policy were implemented with broad bi-partisan support. The Michigan League for Human Services using data from the Department of Treasury Executive Budget Appendix on Tax Credits, Deductions and Exemptions FY2005-FY2009 and the Department of Management and Budget Comprehensive Annual Financial Reports has estimated that the cumulative tax changes over time have left us with a situation that in the Real Estate Business is referred to as being upside down. There findings are that the State of Michigan forgoes 60% of potential state tax revenues, while it collects only 40% of potential revenues. That is indicative of a tax structure which no longer serves the State, business interests, or individuals well.

The Impact of Tax Policy on K-12 Funding.

In 2002, the Michigan Association of School Administrators, the Michigan Association of School Business Officials, and the Michigan Association of School Boards commissioned a study which examined tax policy shifts. The study was done by Genesis Consulting, of Lansing and was authored by Douglas C. Drake. Mr. Drake found that there were significant changes in tax policy in the following areas:

1) Income Tax.
   Any tax exemptions or deductions or other changes that reduce collection impact the amount of revenue available for the School Aid Fund (SFA)
2) Sales and Use Tax Policies.
   The definitions of "food", "immediate consumption", "component parts" and other things defined in statute have seen continuous proposals for change. These changes have made a significant reduction in the revenue earmarked to the SFA.

3) Property Tax Issues.
   While Proposal A dramatically reduced the role of property tax in financing K-12 operations, it did not eliminate the tax. Significant changes have been made that reduce the base of the property tax via exemption or deferral of tax liability.
4) Miscellaneous Policies.
   This category sweeps in many areas. They include changes to the Real Estate Transfer Tax, Renaissance Zones, Brownfields exemptions, obsolete personal property and many others. These policies collectively reduce state and local property collections that otherwise would have gone to education funding.
5) Additional Policy Issues.
   Public Act 198 exemptions were in effect before the adoption of Proposal A, as were Tax Increment Finance Authorities (TIFA). Both have caused significant loss of revenue to the SFA.

In June of 2002, Mr. Drake estimated the loss of revenue to the School Aid Fund for the 2002 budget to be $549,673,939 from the changes in policy after the adoption of Proposal A. He further estimated the impact of the policies in effect before the adoption of Proposal A reduced the budget by additional $331,180,564.

Mr. Drake also pegged the cumulative loss to the School Aid Fund at $2,649,444,512 during the first eight years of Proposal A funding.

There have been many tax policy changes since June of 2002. While no official studies have been done to update Mr. Drake's findings, estimates of the current loss of potential revenue are said to be well over a billion dollars per year.

Hold Harmless Provisions.
In his report, Mr. Drake notes that in very few instances did the Legislature include hold harmless provisions for the local school districts or the SFA. He writes, "In some cases it seem that there may have been an incomplete understanding of the impact of some changes on local revenues as well as state revenues." He draws that conclusion because some legislative bill analyses noted state revenue impacts of proposed property tax or economic development incentive legislation, but omitted any discussion of the impact on the 18 mills, or on special education, vocational education or debt millage.

Not included in the discussions by Mr. Drake, are the provisions of the Renaissance Zone Act. Amended in December of 2002, the Act reads as follows in part:

125.2692 Reimbursement to intermediate school districts, local school districts, community college districts, public libraries, and school aid fund.

Sec. 12.

(1) This state shall reimburse intermediate school districts each year for all tax revenue lost as the result of the exemption of property under this act, based on the property's taxable value in that year, from taxes levied under section 625a of the revised school code, 1976 PA 451, MCL 380.625a; from taxes levied for area vocational-technical program operating purposes under section 681 of the revised school code, 1976

PA 451, MCL 380.681; and from taxes levied for special education operating purposes under section 1724a of the revised school code, 1976 PA 451, MCL 380.1724a.

(2) This state shall reimburse local school districts each year for all tax revenue lost as the result of the exemption of property under this act from taxes levied under section 1211 of the revised school code, 1976 PA 451, MCL 380.1211, based on the property's taxable value in that year.

(3) This state shall reimburse a community college district and a public library each year for all tax revenue lost as a result of the exemption of property under this act, based on the property's taxable value in that year, from taxes levied or collected under the general property tax act, 1893 PA 206, MCL 211.1 to 211.157.

(4) Intermediate school districts, community college districts, and public libraries eligible for reimbursement under subsections (1) and (3) shall report to and on a date determined by the department of treasury all revenue lost for which reimbursement under subsections (1) and (3) is claimed. A local school district eligible for reimbursement under subsection (2) shall report each year on a date determined by the department of treasury all revenue lost for which reimbursement under subsection (2) is claimed.

(5) This state shall reimburse the school aid fund for all revenues lost as the result of the establishment of renaissance zones. Foundation allowances calculated under section 20 of the state school aid act of 1979, 1979 PA 94, MCL 388.1620, shall not be reduced as a result of lost revenues arising from this act.

Subsection (5) has been routinely ignored in past years. In the 2008-2009 School Aid Budget, the SFA paid $41,400,000 to fulfill the hold harmless provisions to local school districts and ISD's. That payment reduced the money available for foundation allowances by nearly $26 per student in a year when the basic foundation was increased only $56, less than half of the Cost of Living Index increase.

Conclusions.
From the foregoing, one can extrapolate that since the State took control of the majority of school funding with the adoption of Proposal A, several things have occurred.

- Ninety five percent of school districts were doing worse after ten years of Proposal A funding, and are probably still doing worse as increases to the foundation allowance have been reduced over time.
- General Fund support for the School Aid Fund in 1993 was $716.6 million. The lack of General Fund revenue due to tax reductions has caused that amount to be almost eliminated. The General Fund contribution for the 2008-2009 budget was down to $40.8 million.
- The hold harmless provisions of the Renaissance Zone Act are actually costing the School Aid Fund $41.4 million in the 2008-2009 budget year. The impact is that all districts including the district that contains the Renaissance Zone get to share the cost.
- The money foregone using Douglas Drake's 2002 calculations would easily be enough to defray the projected School Aid Fund deficits of approximately $850 million in the 2008-2009 and 2009-2010 budgets.
- We are "upside down" with our tax policy by collecting less revenue than the revenue we forgive.

There are so far in this legislative session approximately 160 tax policy bills assigned to or been acted on by the Tax Policy Committee. Many of these proposed changes would be regarded as good tax policy by most observers. It is however legitimate to question the final fiscal impact of all these well-intentioned reforms. With major portions of these taxes earmarked to the School Aid Fund, one unrealized result is a significant reduction in current revenue and the future growth of SAF funding. It is also legitimate to question whether we should quit trying to develop tax policy one bill at a time or whether the time has come to re-examine our approach to "what gets" and "why we apply taxes".

Respectfully submitted,
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