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Funding Local Governments in Michigan

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Executive Summary:

The state of Michigan faces a unique set of issues in its municipal finance system. Since Michigan's "Lost Decade," local governments have seen state obligations to provide revenue go unmet. This decrease in funding has exacerbated issues faced by Michigan's post-industrial cities. Compared to the rest of the country, Michigan local governments are severely restricted in how they accommodate revenue loss from the state.

In order to address the needs of specific local governments and create strong tax bases for economic growth, Michigan should implement regional revenue sharing in a manner similar to Minnesota. Although updating the current system may provide returns in the short-run, regional revenue sharing can help ameliorate inequality and promote economic growth in the long term.

Problem Summary:

Revenue sharing presents four main problems for local governments and communities in the state of Michigan. First, by placing limits on local revenue-raising and failing to provide proper funds in return, Michigan's revenue sharing model incubates financial distress. Although local officials

are reporting fewer signs of distress, a quarter of municipalities are still suffering.[1] Second, issues of financial distress are exacerbated by the funding formula used to award revenue sharing dollars which fails to account for community needs. Third, revenue sharing inherently undermines local control and increases dependence on the state which makes it difficult to ascertain accountability. Lastly, Michigan faces unique challenges in its revenue sharing system which may make the above problems worse. Compared to the rest of the country, Michigan has some of the most stringent tax-expenditure limits (TEL) as well as the highest cost of labor and highest number of local governments that require funding. All of these problems point to the need for significant reform in how revenue sharing is done in the state of Michigan.

1.) Revenue sharing incubates financial distress.

Local governments have been working under growing financial strain due to Michigan's restrictive revenue-sharing model. Under this model, 20% of Michigan's sales tax is returned to local governments. For the past sixteen years, however, lawmakers in Lansing have redirected money away from local governments in order to accommodate budgetary shortfalls. This has resulted in a loss of $7.4 billion for local governments.[2]

Financial strain from Lansing is exacerbated by restrictions on how local governments collect revenue. Local governments may raise revenue independently through property taxes which are capped under certain rates of inflation. Declining property values in the state has diminished the ability for local officials to pave roads, build libraries, and provide safety services. In some cases,

[1] Horner, Debra. Michigan Public Policy Survey. http://closup.umich.edu/michigan-public-policy-survey/spring-2016-data/q12a.php.
[2] Michigan Municipal League: Revenue Sharing Fact Sheet. Save MI City. http://www.savemicity.org/wp-content/uploads/2016/03/2014-revenue-sharing-factsheet.pdf

Michigan's revenue-sharing model has only exacerbated financial distress and caused cities to enter bankruptcy or emergency management.[3]

In 1990, Michigan's state government responded to increasing instances of financial distress by creating an emergency management program which would create an alternative to bankruptcy for local governments and school districts. In response to a recession-induced uptick of municipal insolvency in 2011, Lansing approved an increase in power for emergency managers which included the ability to break union contracts and allowing earlier intervention if the state saw issues in advance of bankruptcy.[4] Although this policy has been somewhat successful in returning municipalities into financial solvency, it is only treating a symptom of the state's systematic weakening of local governments' fiscal health.

2.) Revenue sharing fails to invest in areas where the need is greatest.

Although Michigan's revenue sharing formula seems equitable, the economic context of the state has changed dramatically. Today, the jurisdictions where the need is greatest usually end up bearing the largest consequences for the state's shrinking output of funds.

Michigan's revenue sharing formula uses four different factors in assessing where money needs to go:

1. ***Population***: funds are awarded based on the number of people living within a certain jurisdiction

[3] Sapotichne, Joshua. Beyond State Takeovers: Reconsidering the Role of State Government in Local Financial Distress, with Important Lessons for Michigan and Its Embattled Cities
[4] State Role in Local Government Finances. Issue brief. Pew Trust. http://www.pewtrusts.org/~/media/assets/2016/04/pew_state_role_in_local_government_financial_distress.pdf

2. ***Tax effort***: Local governments are awarded more money based on how much they tax themselves. This is a common practice across the country.
3. ***Property tax reimbursement***: As the state legislature has created restrictions on the way in which revenue is raised for local governments, they have attempted to make up for the resulting revenue shortfalls through revenue sharing.
4. ***Origin***: The more that a jurisdiction contributes to the state's revenue tax, the more money they receive in revenue sharing.[5]

Local government's financial insolvency has been exacerbated in urban areas which have been dealing with the post-industrial exodus of manufacturing jobs. Since need is not incorporated into the state's revenue sharing formula, urban areas end up suffering.

The city of Detroit is a classic example of how this works in action. Since the 1960s, Detroit has been plagued by deindustrialization, decaying schools, racial tension, white flight, and a host of other issues. These symptoms came largely as a result of federal housing policy in Detroit and the loss of manufacturing jobs throughout the state. Since 1951, the city of Detroit's workforce has shrunk from 29,000 to 10,500—accompanying the mass population exodus of people from the city. The city's long-term obligations remained intact, however, even as people left for economic opportunity outside of the city. By 2013, Detroit's obligations reached $380 million. Since Detroit has successfully worked through bankruptcy, it is still gaining its bearings in order to eventually reach financial insolvency. At the same time, however, Detroit is attempting to meet is accumulation of obligations by appealing to the state's funding formula—a process which takes

[5] "Revenue Sharing - Michigan in Brief." Revenue Sharing - Michigan in Brief. Accessed December 11, 2016. http://www.michiganinbrief.org/edition06/text/issues/issue-49.htm.

time and is incredibly difficult without support already in place from the state through revenue sharing.[3]

On the other hand, Detroit's metropolitan region has been doing fine particularly due to regional coordination of services. Right outside Detroit, Oakland County has enjoyed a booming economy and the highest incomes in the state. The city of Pontiac in Oakland County is an urban area which just recently emerged from the state's financial control. In response to financial distress, however, Pontiac has been able to coordinate services with other wealthier localities within Oakland County. Although some estimates claim that the state owes $46 million to Pontiac's local government, the city has been doing markedly better than Detroit given its proximity to economic opportunity and larger populations.[6]

3.) Revenue sharing increases the level of dependence on the state and undermines local control.

Inherently, systems of revenue sharing make local governments dependent on the rest of the state in order to remain financially solvent. This is good for local governments during times of economic growth. On the other hand, this can create dire problems for municipalities if the rest of the state is suffering. During times of hardship, it is often easiest for states to cut funds to local government than other services.

This is certainly the case for the state of Michigan. In 2001, as the economy began to sour statewide, the state has failed to meet its revenue sharing obligations. There are historic reasons for this shift in control, however. There are two ways that the state government guarantees funding

[6] Kampe, Paul. "Oakland County Communities Get Creative to Offset Millions Lost in Statewide Revenue Sharing." Oakland County Communities Get Creative to Offset Millions Lost in Statewide Revenue Sharing. 2016. Accessed December 11, 2016. http://www.theoaklandpress.com/general-news/20160405/oakland-county-communities-get-creative-to-offset-millions-lost-in-statewide-revenue-sharing.

for municipalities: constitutional and statutory revenue sharing. Constitutional revenue sharing is set in stone and was first introduced in 1946 as a way to provide steady revenue streams to local governments. On the other hand, statutory revenue sharing was offered in order to account for the loss of independence among local governments in determining revenue sources. The sales tax, income tax, and single business tax were all limited or eliminated by legislation before 2000. In exchange for these changes, the state offered higher standards for statutory revenue funding. By replacing lost revenue with statutory measures, however, it is much easier for the state to ignore these obligations. As the statutory mandate has grown, so has the amount of money which has gone unfunded. Starting in 2003, unfunded statutory revenue sharing went down little by little. These changes have grown and, in 2012 alone, the state has failed to pay roughly $900 million out to local governments.[7]

4.) Revenue sharing in Michigan presents significant challenges when compared to funding structures nationwide.

Compared to the rest of the country, funding systems for local government in the state of Michigan present three main challenges: high tax-expenditure limits, high number of local governments, and a high cost of labor.

4.1) Michigan imposes a relatively high tax-expenditure limit (TEL) on its local governments.

A tax-expenditure limit is any rule that is put in place in order to restrict the ability of a government to raise revenue or spend money by capping the amount of taxes it can raise to a fixed dollar or to a changing rate of inflation, income, population, or some combination thereof. Only Colorado outranks Michigan in the severity of its tax-expenditure limits since they are the only two states

[7] Lupher, Eric. Citizen's Research Council History of Revenue Sharing. PPT. Lansing: Citizens Research Council. http://crcmich.org/PUBLICAT/2010s/2015/state_revenue_sharing_021815.pdf

with major restrictions on both revenue and spending.[8] How did we get here? In 1978 and 1994, Michigan implemented two strong constitutional TELs. The Headlee Amendment was approved by Michigan voters in 1978 and it capped local property tax millage rates to that of inflation. In 1994, Michigan added Amendment A to its constitution which further limited local property tax revenue growth by attaching local property initiatives to inflation. As a result, state and local lawmakers face strong limits in raising revenue that includes much higher restraints than other states. [3]

4.2) Michigan has an exceptionally high number of local governments to manage.

Michigan ranks 7th in the nation for the number of general purpose local governments. 83 counties, 256 villages, 277 cities, and 1,240 townships round up to 1,856 municipalities that the state is responsible for funding through revenue sharing.[9] Recently, Governor Snyder implemented changes to revenue sharing which reward local governments for sharing assets—a consolidation of services that hopefully helps to cut costs. For many local governments, however, intergovernmental cooperation is already common with 72% of local governments reporting combined service delivery efforts.[10]

4.3) Michigan has strong public unions which increases costs for local governments.

The state of Michigan has a traditional of strong labor organizations. As result, the state has a duty to bargain with public employee unions and has strong union security provisions. This creates

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[8] "What Are Tax and Expenditure Limits?" Tax Policy Center. Accessed December 11, 2016. http://www.taxpolicycenter.org/briefing-book/what-are-tax-and-expenditure-limits.

[9] Horner, Debra. "Michigan Local Governments - Introduction." Lecture, The Gerald R. Ford School of Public Policy, Ann Arbor, Michigan, October 11, 2016.

[10] *Michigan Public Policy Survey Report on Intergovernmental Collaboration*. Report. Center for Local, State, and Urban Policy, University of Michigan. Ann Arbor, MI, 2011.

higher costs for labor relative to other states.[3] Despite higher costs and routine negotiations, it is worth noting that local government officials report having agreeable and collaborative relationship with public employee unions in Michigan. Roughly a quarter of local governments have public sector labor unions. Of those with unions, around 75% had negotiations and report that unions made concessions more frequently than the jurisdiction.[11]

Solutions Summary

In this section, two policies will be reviewed which are aimed at improving funding systems for Michigan's local governments. The first policy focuses on making improvements through Michigan's existing model while the second policy introduces regional revenue sharing, using Minnesota as an example. While working within the Michigan Model is a popular choice for moderate reform among local officials, there is still a need to address the persistent causes of structural need by large municialities. The Minnesota Model aims to ameliorate need with a more regional approach between local governments. At the same time, however, dramatic change to a regional model has a variety of risks and may create more confusion for tax-paying citizens in metropolitan areas.

1.) **Michigan Model**: Increase State Funding under Current Model

There are three basic ways in which local governments can attempt to get more money under the current funding model. They can either lobby for an increase in funding from the state in order to meet unmet statuary funding or push for an increase in either constitutional or statutory revenue requirements. Local governments can also advocate for greater independence in deciding when to

[11] *Michigan Public Policy Survey Report on Local Governments continue seeking, and receiving, union concessions*. Report. Center for Local, State, and Urban Policy, University of Michigan. Ann Arbor, MI, October 2013.

raise taxes, which type, and how much. This can either occur by amending current state laws or amending the state constitution to negate the power of the Headlee Amendment and/or Proposal A.

This option is geared toward providing a more consistent revenue stream for local governments in the state of Michigan. Ideally, reform would focus on increasing constitutional requirements for revenue funding which have been much more effective than statutory requirements. Reducing the severity of Michigan's TELs would be most easily pursued through statutory means although constitutional reform should be examined as well.

Local governments which are benefiting the most from revenue funding already would stand to gain the most under a systematic reform of the Michigan Model. They would be better equipped to pursue road funding or economic development projects that are independent of the state. Local control would also help governments develop systems for funding which could best meet their own unique needs and provide more direct accountability between citizens and their government.

Depending on what type of reforms are pursued, businesses and individuals could stand to win or lose in different ways. On one hand, significant increases in property taxes that were illegal before could now be legal. Local governments may also have greater discretion over raising sales taxes and income taxes independently which could lease to tax abuse by local governments.

There would be clear losers from increased revenue sharing obligations from the state and more independent funding by local governments. First, the state government would not like having more money locked into revenue sharing for local governments when some people would prefer to put the money in other state services such as higher education or corrections. Second, the state government would lose responsibility for communities where the size of the tax base is much

smaller than could be possibly expected to fund the government independently. This includes a lot of post-industrial cities that make up southeast and mid-Michigan: Detroit, Flint, Benton Harbor, and Pontiac (just to name a few).

The Michigan Municipal League—a group representing local governments—has advocated most strongly for compelling the state to pay its unmet obligations.[12] According to the Michigan Public Policy Survey, local officials themselves are mixed on whether or not they believe the current model can allow them to adequately maintain and improve services. However, a majority of local officials (70%) believe that compelling the state to pay unfunded mandates and full statutory obligations should be the top priorities in helping local governments.[1]

(To see the full break down of local officials' top choices for changing revenue sharing, see below.)

While many of these potential reforms may be important, we're interested in the reforms you believe are most critical. Looking at the potential changes listed above in Q14 that you support, please identify which you feel are the top three priorities for how Michigan's system of funding local government should be reformed. Top priority:

	County	Township	City	Village
Enable regional tax-base sharing among local units	0%	1%	1%	0%
Reform tax increment financing/tax captures	14%	1%	1%	2%
Allow local governments to raise revenues through local-option taxes	3%	2%	6%	1%
State pays for unfunded mandates	44%	52%	15%	27%
Increase maximum allowable local millage rates	2%	2%	1%	2%
Reform Headlee Amendment	5%	9%	10%	14%
Establish automatic millage rate roll-ups	4%	2%	1%	2%
Reform Proposal A	3%	3%	9%	5%
Restore full statutory revenue sharing	19%	23%	53%	47%
Add services that are not currently taxed to the state sales tax base	3%	1%	1%	1%
Increase rates on state taxes with revenue-sharing components	3%	2%	0%	0%
Other	0%	2%	0%	0%

[12] *Michigan Municipal League:* "Issue Papers & Legislative Briefs." Issue Papers. Accessed December 12, 2016. http://www.mml.org/advocacy/resources.html.

Governor Snyder has recently signaled modest increases in the amount of money available to local governments through revenue sharing as the state budget has shown signs of modest growth. At the same time, additional requirements from Snyder's office for local governments to receive revenue sharing investments have proven that Snyder is more interested in managing local governments from Lansing with what little funds are available. Given Snyder's strong anti-tax agenda for economic revitalization, it is unlikely that he would support giving local governments more autonomy in how they choose to raise funds.[13]

2.) **Minnesota Model**: Regional Revenue Sharing

Minnesota's revenue sharing model has one major characteristic that distinguishes it from Michigan: regional revenue sharing allocated based on need. City Local Government Aid (LGA) has existed in one form or another in Minnesota since 1971. The model was originally inspired by Minneapolis (Minnesota's largest city) which saw more daytime residents use city services at work during the day than those that actually lived in the city.

Generally speaking, this aid is meant to provide revenue to cities from jurisdictions in the surrounding area. This model is utilized for cities which have seen reduction in population in the last forty years. It also factors in other criteria which indicate need such as aging housing, population, and level of density.[14] Minnesota spends around $515 million a year on the new formula which goes toward funding around 90% of Minnesota's cities. The Minnesota model has

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[13] Oosting, Jonathan |. "How Michigan's Revenue Sharing 'raid' Cost Communities Billions for Local Services." MLive.com. 2014. Accessed December 12, 2016. http://www.mlive.com/lansing-news/index.ssf/2014/03/michigan_revenue_sharing_strug.html.

[14] Politics St. Paul, Minn. · Feb 14, 2011. "The Basics of Local Government Aid in Minnesota." Minnesota Public Radio News. 2011. Accessed December 12, 2016. https://www.mprnews.org/story/2010/09/09/ground-level-city-budget-101.

done a lot to reduce inequality between cities and their metropolitan areas. Since 1970, Minnesota's Gini Coefficient (a measurement of inequality) has gone down by 20% as a result.[15]

Michigan, like Minnesota, faces a strong collective bargaining environment which creates a higher cost of labor. Additionally, Michigan also shares a high number of commuter cities which have undergone drastic population changes in the last forty years. Unlike Minnesota, Michigan faces much more severe TEL requirements and a less even distribution of state aid for local governments.[3]

If regional revenue sharing were introduced to Michigan, former industrial centers in urban areas would benefit the most. Cities like Detroit and Flint have been debilitated by a shrinking tax base and aging infrastructure. It is also incredibly difficult to collect sizable revenue from people who work in the city that benefit from its resources on the weekdays. It is possible that the benefits of revenue sharing would not be seen, however, without accompanying changes to the level of investment by the state.

Depending on how revenue models play out in the long run, it is likely that metropolitan areas in Michigan may stand to lose money. At the same time, the residents of these areas will be helping to fund the actual collective costs of living in more economically developed residential communities.

It is difficult to say whether or not the state would stand to benefit from regional revenue sharing. On one hand, this would help the state lessen its responsibility for cities that have to enter their supervision under emergency management. On the other hand, it could create a situation in which they would actually have to meet the needs of communities which have been underfunded in the

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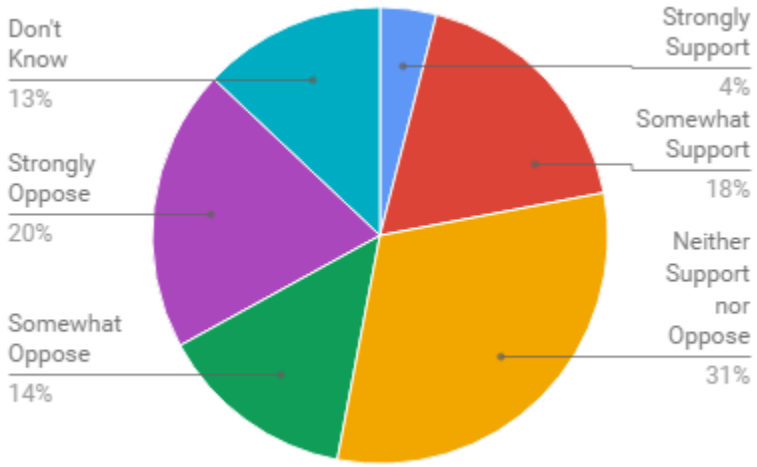
last few decades. Ideally, a regional revenue sharing program would help cities become centers for economic growth and provide even more revenue in return to the state as well as the surrounding region.

In the past, groups like the Michigan Municipal League have not made strong recommendations for regional revenue sharing. According to the Michigan Public Policy Survey, local officials are broadly mixed on their opinion as to whether or not they support regional revenue sharing or if their jurisdiction would participate in such a plan. Generally speaking, cities are more supportive of the idea. It is also worth noting that officials that neither supported nor opposed regional revenue sharing composed the most popular response category at about 31%.[1]

If your jurisdiction had the authority to raise additional local revenues — including options that may not be available currently — would you support or oppose your jurisdiction introducing or increasing regional tax base sharing?



Recommendation

Although it would be politically safe and helpful for metropolitan governments in the short run, the system for funding local governments in Michigan is broken. Severe TELs are almost impossible to overturn and it is difficult to make any changes—statutory or constitutional—without facing backlash. In the long term, it would be wise for state and local governments in the state of Michigan to adopt a regional revenue sharing model, like the one in Minnesota. This would do a lot to help ameliorate inequalities within the state and position Michigan's cities to

become economic drivers instead of the state government's next emergency management project. Although tying local governments' fortune to region and the rest of the state may seem risky, Michigan has always existed within that reality. In acknowledging the regional nature of life in Michigan, the state government would be better off in pursuing regional reforms that mimic the ones in Minnesota.

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