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Understanding trends in state revenue sharing with local governments in Michigan

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Over the past few years, discretionary cutbacks in state revenue sharing, as well as other related fiscal and economic factors, have led to budgetary challenges for local governments across the country, including those in Michigan. To study this issue in depth, the author looks at trends in revenue sharing between state and local governments in Michigan since the early 2000s.

This *Chicago Fed Letter* examines the general role of state revenue sharing in local governments' budgets by focusing on the case of Michigan. Many observers have asserted that a major contributor to the financial difficulties of local governments in Michigan has been the significant drop in revenue sharing funds from the state government. To study this assertion, I examine the roots of the fiscal problems facing Michigan's local governments in recent years and the ways in which these governments have been dealing with diminished tax revenue bases.

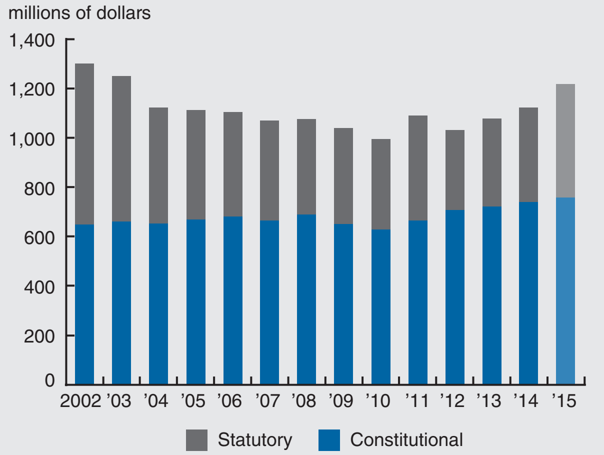
Michigan's local governments began to experience fiscal stress about a decade ago, when the state economy started to perform poorly. More recently, the financial conditions of many local governments in Michigan continued to deteriorate even as the state government saw surpluses following the Great Recession. Consequently, multiple units of local government—including the City of Detroit, the Detroit Public Schools, and the City of Flint—have been under the authority of state-appointed emergency managers (EMs), who have the task of returning these public entities to fiscal solvency. If an EM determines that fiscal solvency cannot be regained through cost-cutting, the selling of assets, and negotiations with creditors, that EM can ask for state approval to take the public entity into bankruptcy proceedings, which is what happened with the City of Detroit.[1]

Current trends

Revenue sharing programs can come under stress when economic activity slows, putting state budgets under pressure, which may in turn lead to decreases in revenue sharing with local governments.[2] To a large extent, declining revenue sharing in Michigan has been due to the state's weak economy. Michigan suffered a one-state recession, which began in late 2003 and lasted until mid-2009, when the nation's Great Recession also concluded. During the one-state recession, Michigan experienced decreases in its own-source revenues and population, which ultimately resulted in declining state revenue sharing with local governments. As seen in figure 1, since 2002, local governments in Michigan have generally received fewer revenue sharing funds from the state with each passing year.

The long decline in state funds available for revenue sharing with localities can best be understood by examining indicators of Michigan's economy. The 2010 U.S. Census revealed that Michigan was

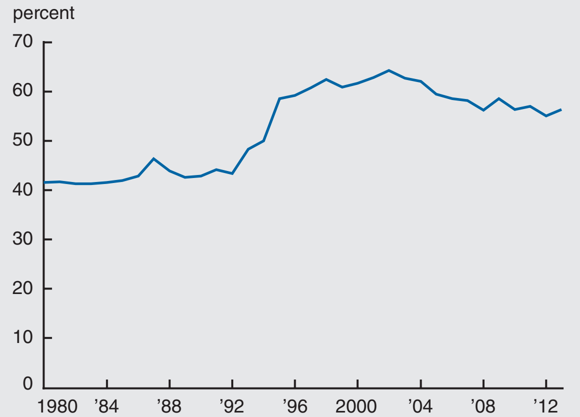
1. Michigan's state revenue sharing with local governments



NOTE: The fiscal year 2015 value is a State of Michigan estimate.

SOURCES: Fiscal years 2002–05 data from the Michigan House of Representatives, House Fiscal Agency, available at www.house.mi.gov/hfa/PDF/GeneralGovernment/EVIP_Memo.pdf; and fiscal years 2006–15 data from the State of Michigan, available at www.michigan.gov/documents/ActualEstPayments_3018_7.pdf?20130801162626.

2. Michigan's state revenue sharing as share of state spending



NOTE: This figure displays state revenue sharing with local governments as a percentage of state spending from only state revenue resources for fiscal years 1980–2013.

SOURCES: Annual reports titled "Statement of the proportion of total state spending from state sources paid to units of local government (legal basis)" from the Library of Michigan.

the only state to lose population during the period 2000–10.[3] The population loss was brought on by a sharply declining job base and a jump in unemployment. Meanwhile, Michigan's residential real estate sector suffered a severe downturn. Michigan is not commonly identified with the mid-2000s housing price bubble. However, Michigan's drop in housing market activity during that time was comparable to what happened in those places that were hardest hit by the housing crisis. Today, new home construction in Michigan remains around 67% below its long-term trend—twice the gap that exists between overall U.S. new home construction and its long-term trend.[4] And with home prices having decreased sharply statewide over the 2006–12 period,[5] taxable home values are down significantly. Amid all these difficulties, retail sales on an annual basis were lower in 2009–10 than in 2002–08, which meant that the state had fewer sales tax collections—the primary basis of the state's revenue sharing program.[6]

As evident in figure 1, the state's revenue sharing with local governments in Michigan is composed of two parts: a portion that is determined by the formula set forth in the state constitution and a portion that is based on the formula set by the state statutory program in place at the time. Since 2002, revenue sharing funds as mandated in the state constitution have been fairly flat, while such funds from the statutory program have fallen sharply.

In Michigan, constitutionally mandated state revenue sharing with local governments began with the passage of an amendment to the state constitution in 1946;[7] under article IX, section 10 of the Michigan Constitution, the state government must share sales tax revenue with local governments.[8] In 1963, the amendment was modified to apportion 15% of the 4% statewide sales tax revenue to local governments on a per capita basis.[9] A locality's population count is determined by the U.S. Census Bureau and adjusted by subtracting 50% of the number of patients, wards, and convicts confined to public-tax-supported institutions within its borders.[10] Although certain individual units of local government might have gotten fewer funds from the state under this formulation in recent years, the overall levels of constitutionally mandated state revenue sharing have stayed fairly consistent over the past 13 years.

In contrast, there has been a clear trend in falling statutory revenue sharing. This pattern can be traced back to the early part of the last decade, when the State of Michigan started to face significant budgetary pressures. From then on, the state addressed its own fiscal problems partly through deep cuts to the existing statutory revenue sharing program. Over the period 1999–2010, statutory revenue sharing amounts were distributed according to a formula that was based generally on taxable home value per capita and population.[11] Hence, those communities most adversely affected by economic travails (i.e., those that were already experiencing dramatic home value declines and population flight) tended to have their fiscal stress magnified by the erosion of state revenue sharing funds under this distribution formula. Shortly after Governor Rick Snyder took office in 2011, the Economic Vitality Incentive Program (EVIP) became Michigan's statutory revenue sharing program. Local governments that received revenue sharing funds through the EVIP got significantly less than what they would have under the previous statutory revenue formula (e.g., in 2012 and 2013, local governments received a combined $173.5 million less than they would have).[12] For fiscal year 2015, the City, Village, and Township Revenue Sharing (CVTRS) program has replaced the EVIP.[13] Like the EVIP, the CVTRS program is likely to fall short of fully restoring statutory revenue sharing funds to levels before Michigan's one-state recession (see figure 1). Given these policy changes, it is easy to see why state revenue sharing in Michigan

3. Share of local government budgets from the state, 2010

A. Seventh District		B. Top five across United States	
Michigan	43.3	Vermont	66.2
Wisconsin	39.6	Arkansas	55.5
Indiana	36.7	New Mexico	48.9
Iowa	31.3	Delaware	47.1
Illinois	28.5	Michigan	43.3
		U.S.	33.1

Note: The U.S. value is the total dollar amount in state revenue sharing divided by the total dollar amount of local government budgets across all states.

Source: Author's calculations based on data from the U.S. Census Bureau, 2011 *Annual Survey of State & Local Government Finances*, available at http://www2.census.gov/govs/local/11slsstab1a.xls.

has fallen since the early 2000s. As shown in figure 2, state revenue sharing as a percentage of state spending from state resources fell to 56.3% in 2013 from its peak of 64.3% in 2002.

There is a wider context for understanding the impact of Michigan's declining state revenue sharing with localities since the early 2000s. In 1994, the state imposed a 2 percentage point increase in its sales tax (from 4% to 6%) to help fund a much-expanded local school aid system (as mandated by Proposal A, which I discuss in more detail later).[14] And so, for most of the 1990s and early 2000s, local governments in Michigan became more dependent on state revenue sharing than those in most other states—and this relatively high state dependence remains in place today. As seen in panel A of figure 3, among communities of states in the Seventh Federal Reserve District,[15] local governments in Michigan are the most reliant on state funding (with 43.3% of their budgets funded by the state); among all U.S. communities, Michigan localities rank fifth in this regard (see panel B of figure 3). In fiscal year 2012, state revenue sharing with local governments represented almost three-fifths (nearly $15 billion) of all state spending from state resources.[16] Figure 2 shows that the percentage of state resources dedicated to intergovernmental revenue sharing has fallen since the beginning of Michigan's one-state recession, but has remained above its constitutional mandate (of 48.97%).[17]

Local fiscal ability

Michigan's economic collapse during the past decade also directly impacted local governments' own-source revenue-raising abilities. More specifically, the deep drop in Michigan home values greatly stressed local budgets because local governments depend so highly on property taxes to fund their services. While local own-source revenues declined (along with revenue sharing funds from the state), local governments were hamstrung in raising new revenues themselves from their own communities. The 1978 Headlee Amendment to the Michigan Constitution explicitly forbids the use of some alternative revenue sources for local governments in Michigan that are employed in other states: Local governments are limited in their local income tax options; they may not institute taxes such as sales or motor fuel taxes; and their use of the local property tax is tightly constrained.[18] The vast majority of states place some limitations on the local property tax, but Michigan is among the very few with all four types of limitations (revenue, levy, rate, and assessment limits).[19] More specifically, local property and other local taxes may not be raised without local voter approval.[20] If Michigan's property tax revenue base is broadened, property tax rates must decrease. If property values (excluding those for new construction and improvements) increase at a rate greater than inflation, property tax rates must be adjusted in order to maintain the same gross revenue (changing strictly in line with inflation alone).[21] However, property tax rates are allowed to drop at a rate greater than the inflation rate.[22]

A related feature currently putting additional fiscal stress on local governments is the manner in which Michigan schools are funded. Michigan schools' operating expenditures are funded primarily through state tax revenues as a result of the passage of Proposal A in 1994.[23] While this program shifts the responsibility for funding education (equitably across school districts) to the state, it also exposes local education funding to any budget difficulties the state may experience. After Michigan's recession began in 2003, state revenue sharing to local school districts decreased. And despite Michigan's economic rebound since mid-2009, local school districts remain fiscally challenged, in part because of recent spikes in teacher retirement costs.[24]

Conclusion

While economic downturns clearly put pressure on state and local governments alike, in Michigan's case they have also added volatility and uncertainty into the revenue relationships between state and local governments. Because of changes to Michigan's statutory revenue sharing program and tax code, local government officials have become increasingly uncertain that statutory revenue sharing will reach pre-2003 levels. Local governments in Michigan may be forced to adjust what their services programs can deliver because of expected lower amounts of state aid over the medium term and possibly the long term. Meanwhile, Michigan localities' latitude to maintain their own programs with their own revenue sources is seemingly limited by law.

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[1] For more details on Detroit's bankruptcy filing, see www.chicagofed.org/webpages/publications/chicago_fed_letter/2013/november_316.cfm.

[2] Other research has found the tendency of state governments to cut local government aid during times of economic stress; see, e.g., http://publius.oxfordjournals.org/content/early/2013/11/17/publius.pjt039.full (available by subscription).

[3] See table 1 on p. 2 of www.census.gov/prod/cen2010/briefs/c2010br-01.pdf.

[4] Author's calculations based on data from the U.S. Census Bureau.

[5] Ibid.

[6] See exhibit 3 on p. 8 of www.michigan.gov/documents/treasury/SalesUseTaxReport2012_432538_7.pdf.

[7] See p. 9 of http://sites.udel.edu/ninadavid/files/2013/09/POLICY-STUDIO-CONSTITUTIONAL-REVENUE-SHARING-REPORT-FINAL-SEPT-2012.pdf.

[8] See www.legislature.mi.gov/(S(e04gak55sqo4h455o5bbamvb))/mileg.aspx?page=getObject&objectName=mcl-Article-IX-10.

[9] Ibid.

[10] See www.mi.gov/treasury/0,1607,7-121-1751_2197-5658–,00.html.

[11] For the fiscal year (FY) 1999 statutory revenue sharing formula, see www.michigan.gov/treasury/0,4679,7-121-1751_2197-5658–,00.html. Michigan's statutory revenue sharing formula was frozen in FY2001 because of the recession back then. Over the period FY2001–10, local governments' statutory revenue sharing payment was based on their 2000 receipt of statutory revenue sharing funds plus Michigan's state budget; see 24th slide of www.crcmich.org/PUBLICAT/2010s/2012/EMU_USRS_History_01-31-12.pdf.

[12] Author's calculations based on data from www.michigan.gov/documents/ActualEstPayments_3018_7.pdf?20130801162626.

[13] See www.plantemoran.com/perspectives/articles/2014/Pages/evip-update-and-tif-reimbursement-reporting-deadline.aspx and www.michigan.gov/documents/treasury/Detailed_Guidance_FY15_CVT_468245_7.pdf.

[14] See www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2004/cfljune2004_203.pdf.

[15] The Seventh District comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

[16] See www.crcmich.org/PUBLICAT/2010s/2012/sbn2012-03.html.

[17] See note 5 on last page of www.michigan.gov/documents/fy01_sec_30_report_34917_7.pdf.

[18] See http://crcmich.org/TaxOutline/index.html and www.michigantownships.org/revenue_sources.asp. While the Headlee Amendment has limited local revenue-raising powers, it does set state revenue and spending limits and prohibits the state from reducing its share of aid to local governments below a certain threshold or from shifting a tax burden to them; see www.mackinac.org/5574.

[19] Pew Charitable Trusts, 2012, "The local squeeze: Falling revenues and growing demand for services challenge cities, counties, and school districts," report, Washington, DC, June; and www.lincolninst.edu/subcenters/significant-features-property-tax/Report_State_Summaries.aspx.

[20] See http://legislature.mi.gov/doc.aspx?mcl-Article-IX-31.

[21] See p. 512 of http://ippsr.msu.edu/publications/SOSSGrowth.pdf. Also, the Headlee Amendment states that property taxes cannot increase annually by more than 5% or the inflation rate, whichever is less; see www.mml.org/resources/publications/one_pagers/opp_headlee_override.pdf.

[22] See www.clinton-county.org/Departments/Equalization/ProposalATaxableValueDecliningRealEstate.aspx.

[23] For further details on Proposal A, see www.michigan.gov/documents/propa_3172_7.pdf.

[24] See www.freep.com/article/20140203/NEWS06/302030053/Snyder-education-funding-increase-Michigan.