

**A Review and Analysis of
Michigan Tax Policies
Impacting K-12 Finances**

Executive Summary

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AUTHOR'S SOURCES

Sources reviewed for this analysis include but are not limited to: House and Senate Legislative Analyses of the many public acts; the public acts themselves, the various Michigan Tax Outlines of the Citizens Research Council of Michigan; state budget documents; state monthly financial reports; and the detailed work papers of the bi-annual Consensus Revenue Estimating Conferences for various years.

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Executive Summary

Even good state tax policies can sometimes have impacts beyond those expected when they are adopted. This analysis looks at two types of tax policy in Michigan and the impact on K-12 education funding: first, policies which address broad issues or are advocated as corrections for perceived inequities within the tax system; second, specific tax policies aimed at encouraging economic development.

From the perspective of broad tax policy, this report looks at income tax policies, sales and use tax policies, property tax and miscellaneous tax policies. As Figure 1 indicates, all of these are relevant to school finance discussions because they each contribute major portions of the revenue supporting the school aid budget. The analysis then looks specifically at economic development policies such as Public Act 198, Tax Increment Financing Authorities (TIFAs) and other economic development incentives. The policies under formal review have been adopted since the creation of the Proposal A financing system at the end of 1993. The analysis also looks at some policies that were in place prior to Proposal A and continue in effect today, such as Public Act 198 and TIFAs. Finally, the analysis discusses some major policy decisions that were part of Proposal A: the assessment cap and the exemption of residential energy costs from the 2-cent sales tax increase, and others. Excluding these last five above, the report looks at a total of over 70 tax policy changes since 1993.

Sources of State and Local Revenues: FY 2002 K-12 Finance

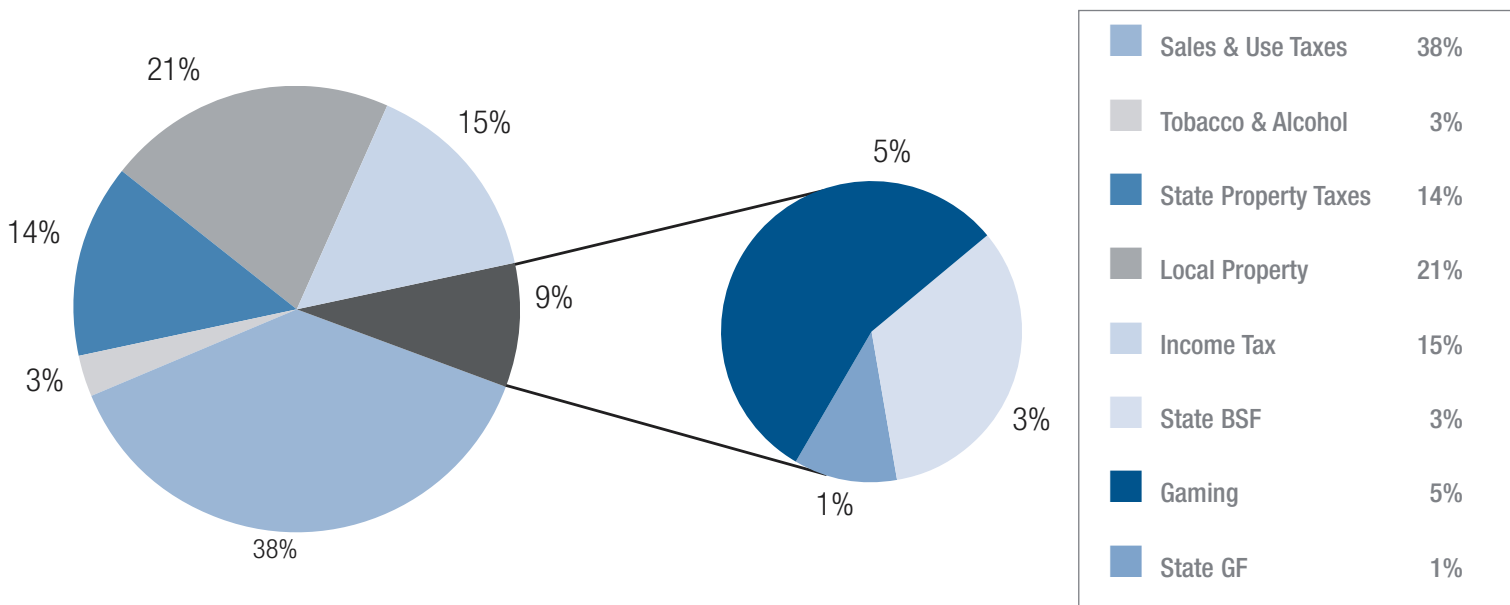


figure 1

Income Tax Policies

A review of income tax policy is critical because roughly 25% of “gross collections before refunds” is earmarked to the School Aid Fund (SAF). In other words, any tax exemptions or deductions or other changes that reduce collections will reduce the amount of funds available for school aid. Policies that work via tax credits will reduce General Fund, General Purpose revenues and the ability of the GFPG to support expenditures but won’t impact the SAF earmarking. The Legislature chose to hold the SAF harmless from the currently scheduled income tax rate reductions by increasing the earmarking percentage.

Income Tax Earmarking Fiscal 2002

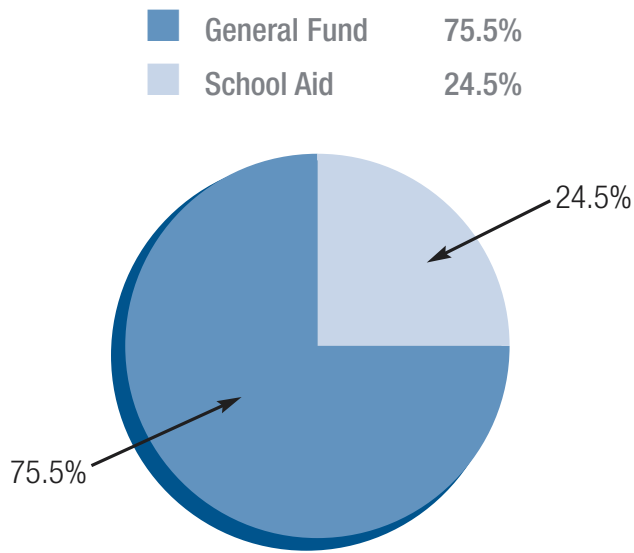


figure 2

Composition of \$155.0 million in figure 3	
	millions
Indexed Personal Exemption	(\$67.6)
Private Pension Deductions	(\$15.6)
Dividend & Interest Deductions	(\$ 5.6)
Child Exemptions	(\$13.6)
Special Exemptions	(\$15.8)
Dependent Exemptions	(\$ 7.1)
College Savings (MESP)	(\$ 1.9)
Federal IRA Changes	(\$27.0)
Federal Student Loan Deductions	(\$ 0.8)
Total	(\$155.0)

That hold harmless provision did not extend to the effects of many other changes enacted into Michigan law over the last eight years, nor has it extended to a number of federal changes that flow-through to the Michigan Income Tax because of its linkages to the definition of adjusted gross income (AGI) for federal purposes.

Figure 3 shows that the combination of the effects of indexing, of new state deductions and exemptions and the flow through impacts of federal changes will result in reduced revenue to the SAF in Fiscal 2002 of an estimated \$155 million compared to the state income tax as it existed in 1994 before Proposal A was implemented.

Income Tax Policy Changes Impacting School Aid

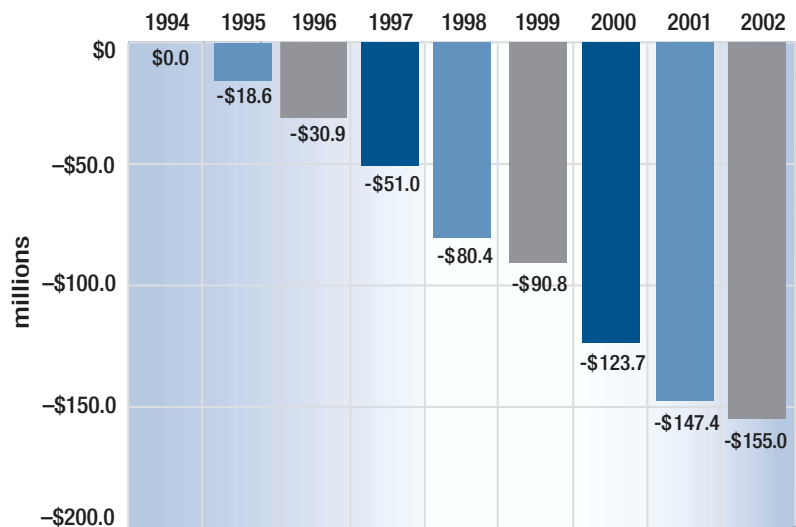


figure 3

Sales and Use Tax Policies

Policy action on the sales and use taxes has clustered in several specific policy areas as well as addressing a number of miscellaneous exemption issues. It has also seen the impacts of other economic reforms and of changes in the structure of the economy itself.

As with the income tax, these deductions and exemptions are critical to SAF funding adequacy because of earmarking: 60% of the first four cents of sales tax is earmarked for the SAF along with 100% of the additional 2 cent increase, together making about 73% of total collections.

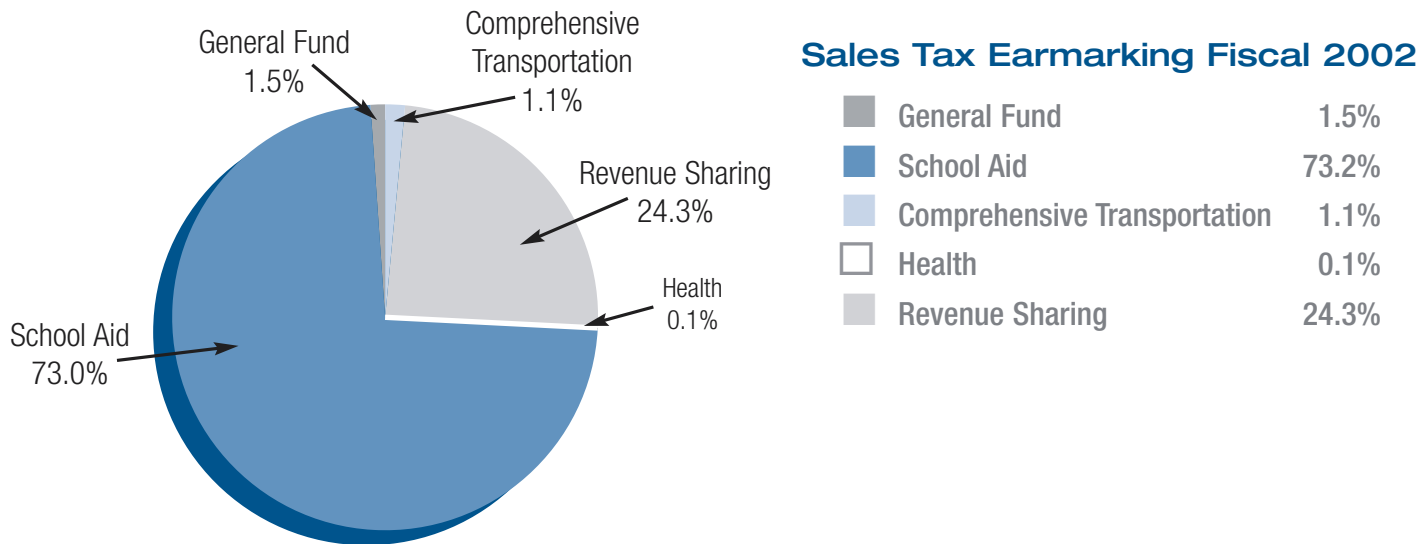


figure 4

Of the use tax, only the additional 2 cents is 100% earmarked to the SAF, or one-third of the six cents total. Because of this differential of 73% versus 33 1/3%, it is more advantageous to the SAF to have an item taxed under the sales tax versus the use tax.

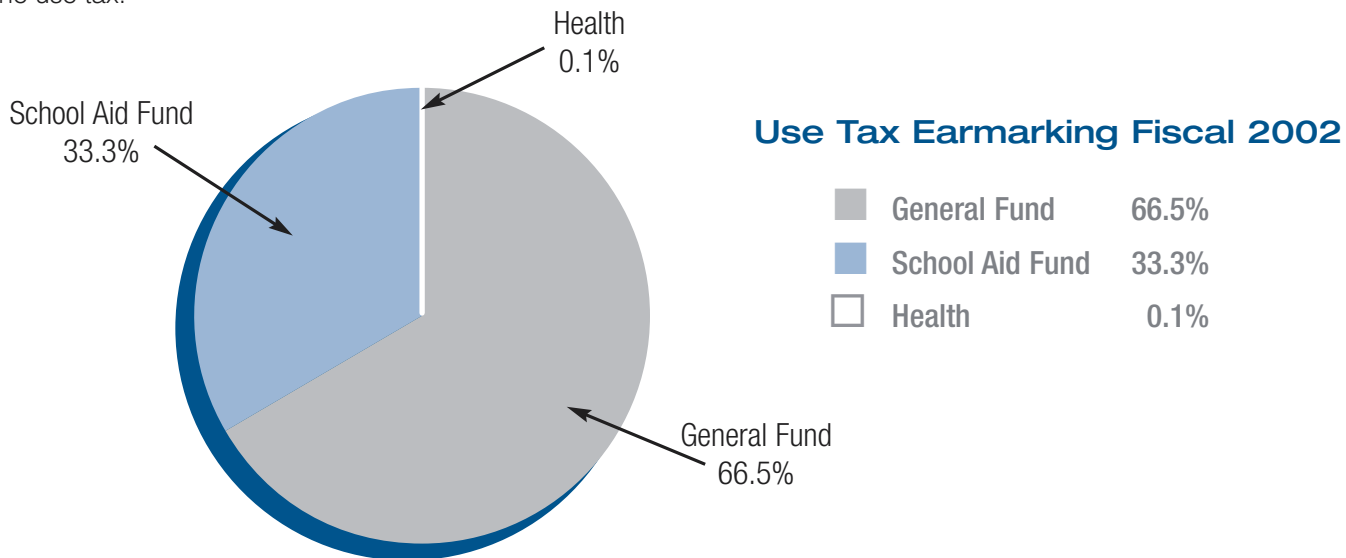


figure 5

The definitions of “food” and “immediate consumption” in terms of Michigan’s 1974 Constitutional amendment exempting food and prescription drugs from the sales tax have been subject to continuous proposals for change. Additionally,

there has been an effort to define the proper limits of exemptions for both purchases and sales by non-profit entities.

Sales & Use Tax Policy Changes Impacting School Aid

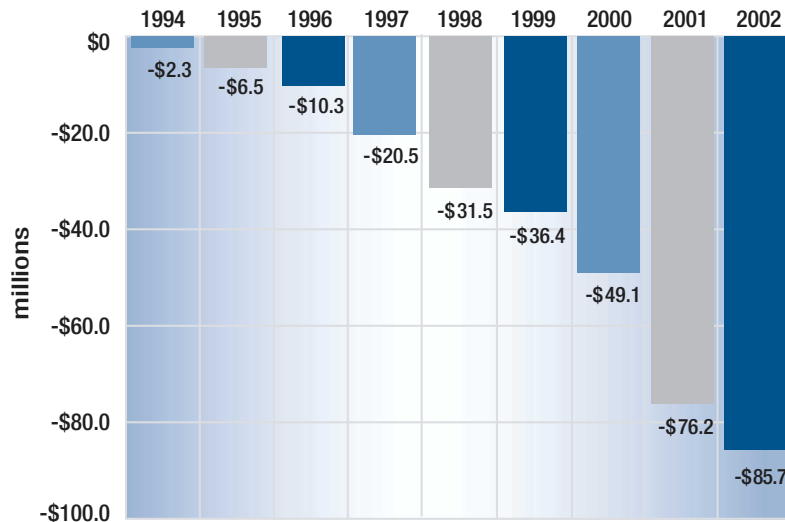


figure 6

Another long-standing area of policy action has been interpretation of the concept of “component parts” in determining exemptions under the rubric of industrial processing, i.e. determining those intermediate components of production that go into a final product which is taxed upon sale and exempting those intermediate components in order to avoid pyramiding sales tax payments.

The estimated total impact of these legislated changes from 1994 to 2002 has resulted in reduced collections of \$85.7 million in Fiscal 2002 for the School Aid Fund from sales and use taxes.

Composition of \$85.7 million in figure 6

	millions
Mobile Vendors Food Sales	(\$ 5.6)
Auto Lemon Law Returns	(\$ 0.7)
Non-Profit Sales & Purchases	(\$ 2.6)
Promotional Materials	(\$ 0.2)
Vended Bakery Products	(\$ 0.4)
Expand Definition of Relatives, Auto Use Tax	(\$ 0.2)
Commercial Advertising	(\$ 3.4)
Telecomm Equipment	(\$ 2.0)
Aircraft, Aircraft Parts, Rolling Stock	(\$ 8.4)
Vended Juice Drinks	(\$ 2.0)
Payment Schedule Changes	+\$ 0.6
Materials for Church Construction	(\$ 2.0)
Industrial Laundry Sales & Purchases	+\$ 0.4
Exempt Certain Hospital Construction	(\$ 0.9)
Payment Schedule, Construction Credit	(\$ 2.1)
Exempt Certain Computer	(\$ 0.6)
Exempt Investment Coins & Bullion	(\$ 0.2)
Apportionment & Industrial Processing	(\$10.7)
Trucks, Parts, Rolling Stock #2	(\$ 8.8)
Use Tax Bad Debt Deduction	(\$ 2.0)
Electrical Deregulation Impact	(\$ 3.1)
Telecomm Reform Imports	(\$ 5.9)
Aircraft #2	(\$ 2.2)
Exempt Employee Meals	(\$ 5.1)
Electrical Deregulation #2	(\$12.0)
Vended Soft Drinks	(\$ 7.8)
Total	(\$85.7)

Finally, the changing structure of the economy itself has a major impact on the growth potential of sales and use taxes. Much has been made to date of “internet” sales taxation. The real issue is much broader, with traditional brick and mortar mall and small town shops facing competition not just from the click of the mouse but also from the speed dialer connecting to an “800” number, or the even older postage stamp, sending an order to a catalog dealer with no physical presence in the home state of the purchaser.

For states, the issue of collection of sales taxes on purchases made by their residents through any remote means may be thought of as a defensive policy. Over time more and more existing tax collections will be lost as sales go to remote vendors and away from traditional brick and mortar stores.

Another longer-term issue will be the developing impact of the changing nature of the American economy as it shifts from a goods-producing base to a services base. Most state sales and use taxes don’t have very broad coverage of services, and Michigan’s is no exception. Indeed, one recent study has found that Michigan has a sales tax base that is only slightly above the national average.

Property Tax Policy Issues

Proposal A dramatically reduced the role of the local property tax in financing K-12 operations. It did not, however, eliminate the tax. The state 6 mill education property tax is a major funding source of the School Aid Fund and the local 18 mill levy on non-homestead property is a critical component of the foundation grant system.

In addition, some K-12s levy so-called hold harmless millages. Many levy sinking fund millages. Most levy debt millages to finance capital projects.

Intermediate districts levy operating millages and earmarked millages for special education and vocational education.

All are impacted by policies that reduce the base of the property tax via exemption or deferral of tax liability.

It is important to note that even though the Proposal A foundation grant system guarantees a given foundation level to a specific district even if its 18 mills does not raise enough local revenue, any reduced yield on that 18 mills due to a property tax exemption means that other SAF funds must replace it, rather than being available to support a higher foundation level.

The total impact of property tax policy changes since 1994 is projected to reduce total collections from all of the above millages by about \$145.4 million in 2002.

Property Tax Policies Impacting SAF

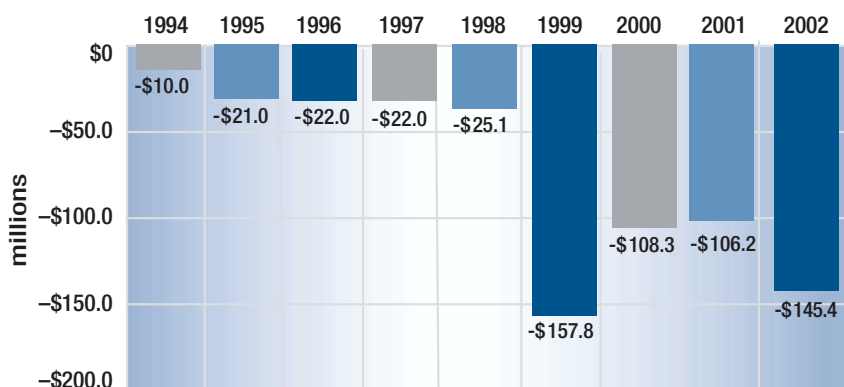


figure 7

Miscellaneous State Tax Policies

A wide range of other taxes earmarked for the SAF are vulnerable to policy changes that could reduce revenues. To date, only one change in these taxes has been made since 1994. An exemption to the state Real Estate Transfer Tax approved in 2000 is estimated to reduce SAF 2002 collections by \$700,000. Note is made here that potential changes to tobacco taxation could also have an impact on SAF revenues due to the high degree of earmarking of that tax.

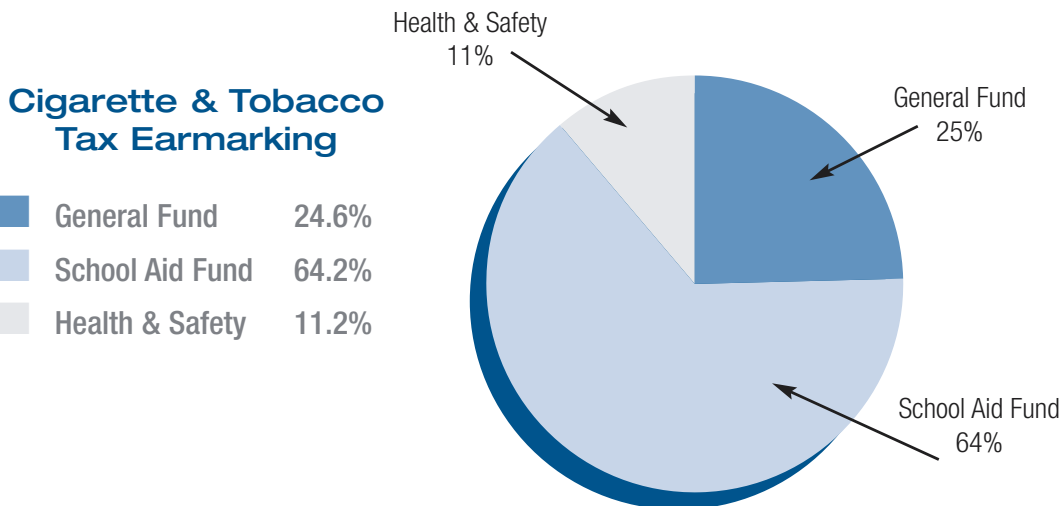


figure 8

MISCELLANEOUS ECONOMIC DEVELOPMENT POLICY ACTIONS

Included in this category are Renaissance Zones, Brownfields exemptions, exemptions for obsolete personal property and many others. Targeted at encouraging economic development, either statewide or in many cases in specific defined distressed areas, these policies have the positive goal of encouraging development and future tax base growth.

Nearly all have the universal short-term impact of reducing collections and modest near-term growth for the hope of faster growth later.

Economic Development Policy Impacts

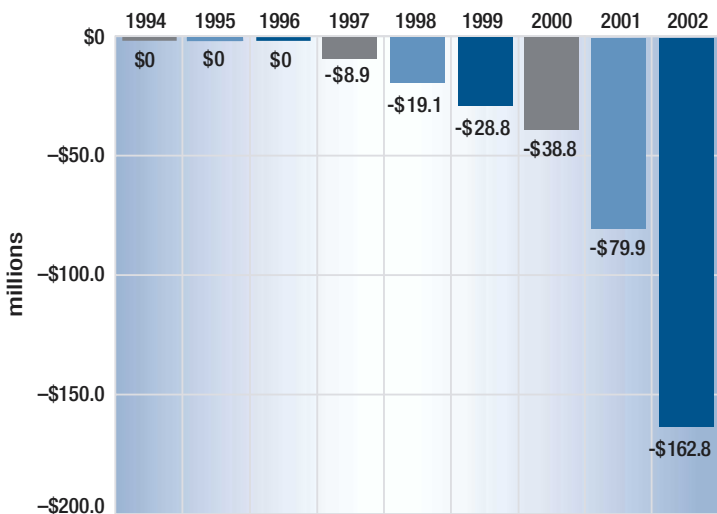


figure 9

These policies collectively will reduce state and local property tax collections that would otherwise have gone to education funding by an estimated \$162.8 million in 2002, after netting out reimbursements paid for certain Renaissance Zone exemptions.

IMPACTS OF POLICY CHANGES SINCE PROPOSAL A

The total impact of the above changes is projected at \$549.7 million for Fiscal 2002. As previously noted, there have been strong tax equity rationales for nearly all of these changes, but **their cumulative impact may be thought of as roughly \$328.00 less available for each of Michigan's K-12 pupils.**

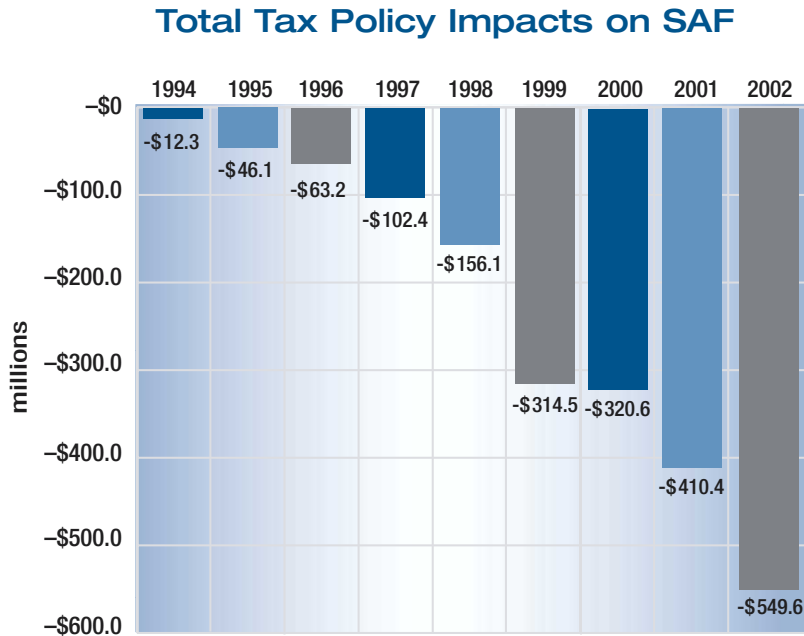


figure 10

Additional Policy Issues

PUBLIC ACT 198 EXEMPTIONS

In existence before the adoption of Proposal A (it was Public Act 198 of 1974), this program offers a tax break for new investment or rehabilitation of existing deteriorated properties. New investments pay one half of the tax rate, while rehab investments pay the full tax rate, but only on the value of the deteriorated property excluding the new value of the rehabilitation investment. Exemption certificates issued prior to 1993 pay half the pre-Proposal A rates and those granted in 1994 and after pay half the lower post-Proposal A rates. PA 198 exemptions may be given for periods of up to twelve years and most are granted for the entire twelve-year period.

The current impact of all 198 exemptions in effect in 2001 is \$244.1 million for all school-related millages, including \$49.0 million for state 6 mill education tax exemptions, authorized in whole or in part by the Michigan Economic Growth Authority (MEGA).

TAX INCREMENT FINANCING AUTHORITIES (TIFAs)

TIFAs were also in place well before Proposal A and continue in effect today. While there are some serious problems with data availability regarding TIFA capture of school taxes, **we can project a 2002 level of capture that probably reduces K-12 revenue by about \$87.0 million.**

OTHER ISSUES

Two integral components of Proposal A, the assessment cap and the exemption of residential energy utilities from the 2 cents sales tax increase also contribute to a significantly reduced level of K-12 revenue compared to the first year of Proposal A. The assessment cap is estimated to reduce 2002 school millages by about \$1,250.0 million, and the exemption of energy utility bills from the 2 cents is estimated to reduce SAF collections by \$206.0 million. Additionally, the income tax rate cut from 4.6 to 4.4% that accompanied Proposal A has reduced the 2002 earmarking to SAF by about \$85.3 million.

Finally, one of the key precursors to Proposal A, the 1992 assessment freeze, was in effect incorporated into Proposal A and contributed to its nature as a net tax cut for Michigan citizens and businesses. Its 2002 impact is estimated at \$167.0 million on education-related property taxes.

Conclusions

Nearly all of these changes would be regarded as good tax policy by most observers. With limited exceptions they make both good common sense and good economic sense. But it is legitimate to inquire into the final fiscal policy impact of all these well-intentioned reforms. With major portions of these taxes earmarked and thus in effect “appropriated” to the SAF, one perhaps unrealized result is a significant reduction in the growth potential of SAF funding.

In a very few instances, principally the income tax rate reductions, the Governor and the Legislature did provide for a hold harmless change in earmarking that kept the SAF whole. In most instances however, even for changes nearly as significant, comparable provisions weren't addressed.

In some cases it seems that there may have been an incomplete understanding of the impact of some changes on local revenues as well as on state revenues. For example, some legislative bill analyses noted the state revenue impacts of proposed property tax or economic development incentive legislation, but omitted discussion of the impacts on the 18 mills, or on special education, vocational education or debt millages. Given the interaction of local and state funds supporting the foundation grants for school districts and the impact of property tax reductions on the other locally levied millages, policymakers should make sure that the full impacts of proposed legislation are reviewed and considered.

Further, given that many of the tax policy changes and especially the economic development incentives have very long lives and indeed tend to be considered as entitlements, policymakers should look at mechanisms for ensuring consideration of the long-term impacts of future changes.

SUMMARY OF PROJECTED IMPACTS ON STATE AND LOCAL K-12 FINANCES CHANGES ENACTED SINCE 1993

	Projected Total Impacts For Fiscal Year 2002	Estimated Cumulative Total: 1994-2002
State Income Tax Policy Changes	\$155,030,411	\$697,886,228
State Sales & Use Tax Policy Changes	\$85,728,078	\$318,467,089
State & Local Property Tax Policy Changes	\$145,392,333	\$616,794,000
Miscellaneous State Tax Policy Changes	\$700,000	\$2,800,000
Economic Development Incentives: Other (Reduced for Renaissance Zone Reimbursements)	\$162,823,117	\$338,320,603
Total Impacts	\$549,673,939	\$1,974,267,920

INFORMATIONAL DISPLAY ONLY OF OTHER RELEVANT POLICY IMPACTS

On-Going Tax Policies In Effect Before Proposal A, With Continued Impacts On K-12 Finances

Economic Development Incentives: PA 198*	\$244,145,363	\$1,953,162,904
Tax Increment Financing Plans (TIFAs)*	\$87,035,201	\$696,281,608
Total These Items	\$331,180,564	\$2,649,444,512

On-Going Tax Policies That Were An Integral Part of Proposal A, With Continued Impacts

Exclusion of Residential Energy Utilities From 2 Cent Sales Tax	\$206,000,000	\$1,474,000,000
Estimated 2002 Impact of Assessment Cap	\$1,250,025,432	\$5,097,603,713
Income tax rate cut from 4.6 to 4.4	\$85,284,000	\$515,458,000
Impact of 1992 Assessment Freeze continued in A	\$167,177,314	\$1,259,156,053
Total These Items	\$1,708,486,746	\$8,346,217,766

**Most cumulative numbers are the sum of annual numbers in the detail appendix tables.*

**This represents the total for all 198 certificates in place in 2001, and the cumulative total is simply 8 years times this total.*

figure 12

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