SCHOOL FINANCE IN MICHIGAN

BEFORE AND AFTER THE

IMPLEMENTATION OF PROPOSAL A:

A COMPARISON OF

FY 1993-94 AND FY 1994-95

APPROACHES TO

K-12 SCHOOL FUNDING

IN MICHIGAN

SENATE FISCAL AGENCY

HOUSE FISCAL AGENCY

FORWARD

The following article describes the major changes in Michigan's school finance system that were implemented in fiscal year (FY) 1994-95. It was originally included as "Appendix A" in the October 1994 publication *The Michigan School Aid Act Compiled and Appendices* which was prepared jointly by staff from the House and Senate Fiscal Agencies.

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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. The result of this change opened the door to an exchange of ideas. The national spotlight was on Michigan for the remainder of 1993 as it wrestled with the issue of replacement revenues. 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. The Legislature opted to let the people of Michigan decide between two revenue proposals for the funding of public schools.

Voters were presented with Proposal A, a constitutional amendment on school finance, in a March 1994 special election. The ballot proposal, if approved, would amend 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. Among the tax changes in the Statutory Plan were an increase in the income tax from 4.6% to 6.0%, an increase in the personal exemption, a State education property tax of 12 mills on nonhomestead property, and an increase in the single business tax rate from 2.35% to 2.75%. The tax changes in each plan are summarized in Table 1. 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.

On March 15, 1994, Michigan voters overwhelmingly approved Proposal A. After many attempts, the goal of reforming the financing of Michigan's public schools and providing property tax relief has been achieved. This document reviews the sources of revenue and the school aid distribution system that will support K-12 education in 1994-95.

This article was originally published in October 1994 as "Appendix A" in *The Michigan School Aid Act Compiled and Appendices.* It was based on an article that appeared in the Senate Fiscal Agency's July/August 1994 issue of *Notes on the Budget and Economy*.

Local School Operating Taxes

Public Act 336 of 1993 and amendments passed in June 1994 (Public Act 283 of 1994) comprise the School Aid Act for the 1994-95 school year. This Act and related School Code legislation marked the beginning of the foundation grant approach to State school aid payments. This was a departure from the district power equalizing approach that had been in effect for almost twenty years. The school finance reform plan also diminished the State's reliance on local school operating property taxes as a source of funding for K-12 public schools. Although some local school operating property taxes were reinstated, they were significantly reduced for most homeowners and businesses in the 558 school districts in Michigan.

Table 1

TAX REFORM COMPONENTS
SCHOOL FINANCE REFORM PACKAGE

Tax Change	Ballot Plan	Statutory Plan
Sales Tax Rate	From 4.0% to 6.0%	No change
Use Tax Rate	From 4.0% to 6.0%	No change
Sales & Use Tax Base Adjustments	Exempt Residential Utilities from two-cent increase Tax Interstate Phone Calls (Exclude 800 Service)	Tax Interstate Phone Calls
Income Tax Rate	From 4.6% to 4.4%	From 4.6% to 6.0%
Income Tax Personal Exemption	No change	From $2,100 to $3,000 per dependent
Income Tax Credit Adjustments	Increase Renter's Credit	Increase Renter's Credit
Single Business Tax Rate*	No change	From 2.35% to 2.75%
Real Estate Transfer Tax**	Impose at 0.75%	Impose at 0.75%
State Education Property Tax		
Homestead and Qualified Ag. Property	Levy 6 mills	None
Nonhomestead Property	Levy 6 mills	Levy 12 mills
Local Homestead Property Tax	None	Levy 12 mills
Local Nonhomestead Property Tax	Levy 18 mills	Levy 12 mills
Cigarette Tax Rate Increase	Increase from 25 cents to 75 cents per pack	Increase from 25 cents to 40 cents per pack
Tax on Other Tobacco Products	Tax at 16.0% of Wholesale Price	Tax at 16.0% of Wholesale Price

* After the approval of Proposal A, Public Act 247 of 1994 reduced the Single Business Tax rate from 2.35% to 2.3%, effective October 1, 1994.

** As passed in December, the Real Estate Transfer Tax would have been 2% under the Ballot Plan and 1% under the Statutory Plan. The rates were reduced to 0.75% by Public Act 3 of 1994 prior to the election.

In 1993-94, the statewide average millage rate for local school operating purposes was just under 34 mills on all property. In 1994-95, for most districts, the local school operating millage rate will be 18 mills on nonhomestead property only. The 18-mill tax on nonhomestead property will provide local school operating revenue and will remain within the school district to serve as a component of the district's foundation allowance. Owners of homestead and qualified agricultural property will pay no local school operating taxes in most areas (except in districts with "hold harmless" or enhancement millage, which is discussed further below).

State Revenues for Education

State revenues for education will change considerably as a result of the adoption of Proposal A. The tax sources going to the School Aid Fund (SAF) will be expanded to include the revenue from the sales and use tax increases, the cigarette tax increase, the new state real estate transfer tax, the tax on tobacco products, and proceeds from the new State education property tax of six mills on all property. From the income tax, 14.4% of gross collections before refunds is now earmarked to the SAF.

The revenues earmarked to the SAF before and after the adoption of Proposal A are compared in Table 2. The new revenue from the sales tax increase is dedicated to the SAF by the constitutional amendment. The other sources are earmarked by State law.

The fiscal year (FY) 1994-95 school aid budget relies on these and other State revenues. There is a General Fund transfer of $667.9 million, including an estimated $228.5 million transferred from the General Fund to the SAF to make up the loss to the SAF from the reduction in the rate of the real estate transfer tax from the 2% rate originally approved to the 0.75% in current law. Another $139.5 million from the Public School Employees Retirement System (PSERS) prefunded reserve for health benefits will be used as a revenue source for the foundation grant program. These funds will reduce the cost of district contributions for teacher retirement and will be considered as part of the State share of the district's foundation allowance.

Table 2

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

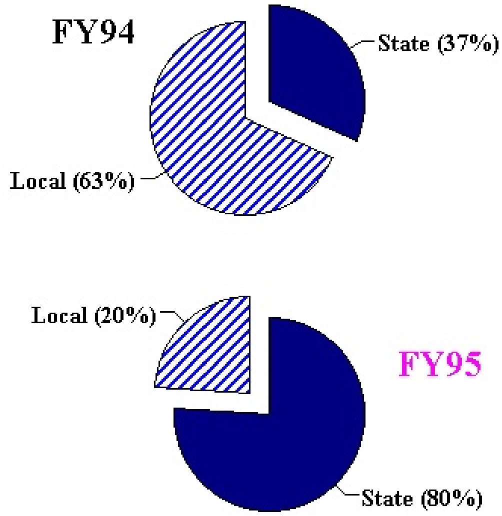
* The effective date of the earmarking changes varies by tax. For new taxes such as the State education tax and the real estate transfer tax, the earmarking begins on the effective date of the tax. The income tax earmarking begins October 1, 1994. The sales, use, cigarette, and other tobacco products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

** Constitutionally dedicated to the School Aid Fund.

The State/Local Funding Split

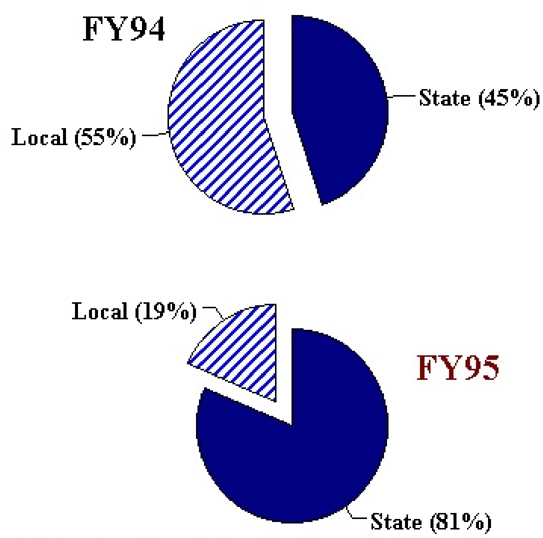
These tax reforms substantially change the financing of K-12 education in Michigan, increasing the share of revenue raised by the State and decreasing the reliance on property taxes as a revenue source. Figures 1 and 2 illustrates these changes. Figure 1 shows that when the direct source of education funds is considered, the share of K-12 education revenue coming from the State increases from an estimated 37% in FY 1993-94 to 80% in FY 1994-95. In Figure 2, the estimated impact of the role of the State's property tax credit in relieving local school taxes is considered. In this analysis, the State share of education revenues changes from an estimated 45% in FY 1993-94 to approximately 81% in FY 1994-95.

Fig. 1: Local/State Funding Mix
Statewide Totals



[Excludes Effect of Homestead Credits]

Fig. 2: Local/State Funding Mix
Statewide Totals



[Includes Effect of Homestead Credits]

District Power Equalizing and State Formula Aid

In recent years, Michigan public schools have been financed through a combination of State aid payments and locally raised revenues. Generally, State aid was provided in two forms: general purpose aid and categorical aid. Most general purpose aid was provided through an equalization formula while special programs and services such as special education, vocational education, bilingual education, and transportation (to name a few) were funded through categorical aid.

Beginning in 1973, the Gilbert E. Bursley School District Equalization Act created a funding equalization formula known as District Power Equalizing. This method was used through the end of the 1993-94 school year. District Power Equalizing guaranteed each district a minimum return per pupil for each mill of property tax levied. Districts were allowed to tax themselves at whatever rate the voters approved, within the 50-mill limit of Article IX, Section 3 of the Michigan Constitution. If a district's revenue from the levied tax rate was less than the State guaranteed revenue from that tax rate, the State paid each district the difference in the form of State formula aid payments.

If a district's local revenue per pupil per mill exceeded the State's guaranteed revenue under the District Power Equalization Formula, the district was "out-of-formula" and thus received no State formula aid. In the 1993-94 school year, 177 of Michigan's 558 school districts were out-of-formula. The remaining 381 school districts received State aid according to the State Membership Aid Formula. In the 1993-94 school year, the guaranteed amount per mill or the equalization payment was $102.50. In addition, the formula included fixed-dollar payments per pupil that could total $400 (assuming that a district met all requirements for receiving certain incentive payments). The total formula aid included the equalization payments, a flat grant of $326 per pupil, and incentive payments of up to $74 per pupil.

The boxes in Figure 3 show the relationships that determined formula aid payments to a school district. First, a district's guaranteed millage revenue was calculated as the product of the local mill rate (in decimal terms) and the State guaranteed amount per pupil per mill. The sum of the guaranteed millage revenue and the flat grant (including incentive payments) was termed the gross allowance per pupil. The guaranteed millage revenue and the gross allowance varied between districts based on the school operating millage rate levied.

A district's State formula aid payment per pupil was computed by taking the difference between the gross allowance per pupil and the local operating revenue per pupil for the district. The local operating revenue was the local school operating millage rate times the State equalized valuation (SEV) per pupil. SEV is equal to 50% of the property's true cash value. If a district's local revenue on its school operating mills was greater than the gross allowance, then the district was out-of-formula and received no State formula aid. Otherwise, the State membership aid per pupil was the difference between the gross allowance for the district and the local operating revenue.

Figure 3

SCHOOL AID MEMBERSHIP FORMULA RELATIONSHIPS

Guaranteed Millage Revenue Per Pupil	=	Guaranteed Amount Per Mill	x	District Tax Rate (Mills)

Gross Allowance Per Pupil	=	Guaranteed Millage Revenue Per Pupil	+	Flat Grant Per Pupil

State Membership Aid Per Pupil = Gross Allowance Per Pupil - Local Operating Revenue Per Pupil

Thus, State formula aid payments per pupil varied among in-formula school districts depending on SEV per pupil. In-formula districts with a higher SEV per pupil received lower State formula aid payments per pupil because they had more local revenue per mill levied. Out-of-formula districts with a higher tax base per pupil could raise more revenue at the same or lower millage rate than a district with a lower tax base. Table 3 provides a clearer illustration of this point.

Table 3

EXAMPLES OF THE TOTAL REVENUE PER PUPIL RECEIVED BY DIFFERENT SCHOOL DISTRICTS WITH VARYING SEVs AND MILLAGE RATES FY 1993-94

(a) District	(b) District Tax Rate (Mills)	(c) Guaranteed Millage Revenue Per Pupil [(b)x $102.50]	(d) Gross Allowance Per Pupil[1] [(c)+$400]	(e) Local SEV Per Pupil	(f) Local Revenue Per Pupil [.001 x(b)x(e)]	(g) State Formula Aid Per Pupil [(d) - (f)]	(h) Total Revenue Per Pupil [The larger of (d) or (f)]
A	30	$3,075	$3,475	$50,000	$1,500	$1,975	$3,475
B	30	$3,075	$3,475	$80,000	$2,400	$1,075	$3,475
C	30	$3,075	$3,475	$125,000	$3,750	$0	$3,750
D	20	$2,050	$2,450	$300,000	$6,000	$0	$6,000

1) Assumes districts qualify for all incentive payments.

Thus, the former way of paying for Michigan's schools created the opportunity for inequity among school districts because districts with high SEVs had the potential to raise much more revenue than did districts with low SEVs.

From a State budget perspective, the appropriation structure for school aid had a significant impact, adding to uncertainty in General Fund expenditures. The appropriation required that if SAF revenues were insufficient to fund fully the requirements of the School Aid Act, then additional General Fund money was automatically appropriated to the SAF. The amount of the General Fund transfer, estimated at the time of the K-12 budget passage, could change during a fiscal year as SAF revenues and the cost of the formula were revised to reflect actual data. The deviations from estimated amounts could occur due to different-than-expected State SAF revenues or local factors such as changes in millage rates, pupil counts, and SEV, all of which would affect the cost of the school aid formula. In tight budget years, increases in the General Fund transfer during the State fiscal year could lead to reductions (negative supplemental budget bills) in other State budgets. Adding stability to State budgeting was an issue addressed in the school finance reforms.

<u>The Foundation Allowance and Michigan's New School Finance Plan</u>

In FY 1994-95, school districts will experience a major change in determining their revenue, moving from the equalization formula to the new school aid system. The primary mechanism for funding schools in the 1994-95 school year will be the foundation allowance. In addition, districts will continue to receive State categorical payments for a selected number of programs such as special education.

The foundation allowance is a per-pupil revenue amount that a district may receive. It is calculated for each district based on a formula in the School Aid Act. In general, the starting point is the amount of eligible base revenue that a district received per pupil in the 1993-94 school year. This base amount is then increased as permitted by law to determine the foundation allowance for FY 1994-95. The increase varies from $250 per pupil for the lower revenue districts to $160 per pupil for the districts with base revenues of $6,500 or more; however, each district will have a foundation allowance of at least $4,200 in FY 1994-95. The FY 1994-95 foundation allowance per pupil for districts with base revenue above $4,200 and less than $6,500 is determined by the following formula:

$$\begin{array}{c}\text{Foundation}\\ \text{Allowance}\\ \text{Per Pupil}\end{array} = \begin{array}{c}\text{Base}\\ \text{Revenue}\\ \text{Per Pupil}\end{array} + \$250 - \left[\$90 \times \frac{(\text{Base Revenue Per Pupil} - \$4{,}200)}{\$2{,}300}\right]$$

To calculate a district's foundation allowance, base revenue per pupil is calculated for fiscal years 1992-93 and 1993-94. If base revenue is lower in 1993-94 than in 1992-93, then the average of the two years is used. Otherwise, the base revenue is the 1993-94 eligible base revenue per pupil.

The revenue that is eligible to be counted in the base generally consists of local school operating property tax revenue and State aid payments for formula aid and categorical programs such as social security that were "rolled up" into the foundation allowance and will not continue as separate categoricals. The State aid payments included in the base are those paid to or on behalf of a district; thus, teacher retirement payments made directly by the State in FY 1993-94 to the Public School Employees Retirement System on behalf of school districts are included.

Local revenues in the base include school operating property taxes and specific taxes levied and retained by the district. In addition, a portion of fund equity expenditures, certain transportation costs, and one-half of gifted and talented payments made to intermediate school districts and passed on to local district are included in the base. The treatment of State payments in the determination of base revenue is detailed in Appendix C.

The foundation allowance is funded from a combination of State aid and local property tax revenue. In order to receive the full foundation allowance, a district must levy local school operating millage on nonhomestead property (generally commercial and industrial property) of 18 mills or the number of mills levied in 1993, whichever is less.

The State share of the foundation allowance is calculated differently for districts above and below $6,500 per pupil. For districts with a foundation allowance of $6,500 or less, the State payment is the difference between the foundation allowance and the local revenue on 18 mills (or the number of mills levied in 1993, whichever is less) levied on nonhomestead property.

Table 4

THE STATE AND LOCAL SHARE OF THE FOUNDATION ALLOWANCE FOR SAMPLE SCHOOL DISTRICTS (amounts per pupil)

District	(a) 1993-94 Blended Base Revenue	(b) 1994-95 Foundation Allowance	(c) Nonhomestead SEV Per Pupil	(d) Local Revenue on 18 Mills .018x(c)	(e) State Share of Foundation Allowance[1]	(f) Local Hold Harmless Revenue Needed[2]	(g) Total Local Revenue Needed (d)+(f)
W	$ 3,850	$ 4,200	$ 25,000	$ 450	$ 3,750	$ 0	$ 450
X	5,100	5,315	80,000	1,440	3,875	0	1,440
Y	7,000	7,160	40,000	720	5,780	660	1,380
Z	9,800	9,960	150,000	2,700	3,800	3,460	6,160

1) The foundation allowance or $6,500 whichever is less, minus the local revenue on 18 mills.
2) For districts with a foundation allowance above $6,500, the foundation allowance less $6,500.

For districts with a foundation allowance of more than $6,500, the State payment per pupil is the difference between $6,500 and the local revenue on 18 mills (or the number of mills levied in 1993, whichever is less) on nonhomestead property. If a district does not levy the 18 mills, the State payment is unchanged and the district does not receive the entire foundation allowance. Table 4 shows examples of how the foundation allowance works. Table 5 explains the millage rates that would be necessary to finance the foundation allowances in Table 4.

Table 5

LOCAL SCHOOL OPERATING MILLAGE RATES FOR SAMPLE SCHOOL DISTRICTS								
					Hold Harmless Millage		Total Local Millage	
District	1994-95 Foundation Allowance Per Pupil	Nonhomestead SEV Per Pupil	Homestead SEV Per Pupil	Local Hold Harmless Revenue Needed Per Pupil	Homestead Property	Nonhomestead Property	Homestead Property	Nonhomestead Property
W	$ 4,200	$ 25,000	$ 50,000	$ 0	0.00	0.00	0.00	18.00
X	5,315	80,000	30,000	0	0.00	0.00	0.00	18.00
Y	7,160	40,000	160,000	660	4.12	0.00	4.12	18.00
Z	9,960	150,000	100,000	3,460	24.64	6.64	24.64	24.64

Note: The State 6.0 mill education property tax will be paid on all taxable property in addition to the local millage rates shown in the table.

For districts with a foundation allowance above $6,500 per pupil, all revenue above the $6,500 per-pupil level must be raised locally through additional millages known as supplemental or "hold harmless" millages. "Hold harmless" millage is first levied on homestead and qualified agricultural property only. "Hold harmless" millage in excess of 18 mills (or the number of operational mills levied in 1993-94, if less) is levied uniformly on all property subject to taxation. The local school operating millages, including "hold harmless" millages, that may be levied are calculated by the Department of Treasury. Exemptions from levying "hold harmless" millage are provided for districts that had fewer than 350 pupils in 1993-94 or that need to levy a "hold harmless" millage of less than 0.5 mill to reach their foundation allowance.

Voter approval is required for all local school operating taxes. Districts that have sufficient existing school operating millage authorization may levy the 18 nonhomestead mills and the "hold harmless" millage, if applicable, under the existing voter approval and hold a vote at the time the authorization expires. Beginning in 1994, voters also may approve enhancement millages of up to three mills that may be levied uniformly on all property through 1996. These millages would support local school operations and would be in addition to other local operating millage.

The school finance reforms also changed the nature of the School Aid Act appropriation from a sum-sufficient appropriation to a capped appropriation of a fixed-dollar amount. In FY 1994-95, if the actual cost of the foundation allowance, perhaps due to further changes in pupil counts or SEV, turns out to be greater than the appropriated amount, Public Act 283 of 1994 specifies that payments to districts shall be prorated to maintain the total State cost at no more than the appropriation. In contrast to the old approach under which the actual cost of the membership formula was automatically funded by the State through changes in the General Fund grant to the SAF, the new system will require a supplemental appropriation bill to increase the amount appropriated for the foundation allowance. If the appropriated amount is greater than the payments required, the excess will remain in the SAF and be carried forward into the next fiscal year.

Conclusion

In the past year, a new framework was created for school finance in Michigan. In addition, changes have been made in education policy and funding such as allowing the operation of public school academies and providing additional funds for at-risk children and early childhood development. The magnitude of the school finance and other changes has meant challenges for local officials and administrators in adapting to the new system; however, the long-sought goals of property tax relief and a new school aid distribution system have been met.