House Legislative Analysis Section

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CHANGE REVENUE SHARING; CUT DETROIT CITY INCOME TAX

House Bill 5391 as enrolled
Public Act 500 of 1998
Sponsor: Rep. Kirk A. Profit
House Committee: Tax Policy
Senate Committee: none

House Bill 5989 as enrolled
Public Act 532 of 1998
Sponsor: Rep. Nick Ciaramitaro
House Committee: Appropriations
Senate Committee: none

Second Analysis (12-15-98)

THE APPARENT PROBLEM:

Under both constitutional and statutory provisions, the state shares, or redistributes, revenue from various state tax sources to local units of government. About 40 percent of total revenue sharing payments to local units of government are paid from constitutionally dedicating a fixed amount of the sales tax (15 percent of gross sales tax collections at the 4 percent rate). This generates an estimated $558 million in fiscal year 1997-98, and is paid to cities, villages, and townships on a per capita basis. The remaining 60 percent of state revenue sharing (about $792 million in 1997-98) is distributed to cities, villages, townships, and counties through a statutory formula.

One component of this statutory revenue sharing formula has been the source of much controversy. Though revenue sharing was originally distributed on a per capita basis, the Revenue Sharing Act of 1971 instituted a relative tax effort formula for distributing most statutory revenue sharing funds. The formula is actually a weighted population distribution, in which a local unit's tax effort is measured by the amount of operating millage levied, plus revenues from local income taxes and utility taxes (where applicable). The resulting amount is converted into a millage rate, which is compared to the statewide average millage rate. The ratio is then multiplied by the local unit's population to arrive at a distribution factor for revenue sharing payments.

The relative tax effort formula was intended to recognize the variation in *need* for local public services, as well as the variation in *ability* to raise revenue at the local level. It was also acknowledged that this weighted formula would help offset the effects of population losses on urban centers. The result of this method of distribution is that the state's largest city, Detroit, receives what many consider to be a disproportionately large share of the state's revenue sharing money. There has been mounting pressure in recent years to shift revenue sharing funds towards a straight per capita distribution system, which is seen by many as a more equitable way to distribute the funds. Unable to resolve the conflict, the legislature in 1996 froze payments based on relative tax effort at fiscal year 1996-97 levels, and specified that any growth in revenue sharing would be distributed on a per capita basis. Further, the legislature took steps to simplify the revenue sharing program by consolidating the tax sources of revenue sharing funds, and created a House-Senate task force to consider broad-based reform of the revenue sharing system. The 1996 legislation further provides that all statutory revenue sharing payments will be frozen at 1997-98 levels. Efforts to produce an agreement on a new distribution formula by September 30, 1998 were unsuccessful, so all growth in revenue sharing funds for the current fiscal year is being placed into a special reserve account.

It is proposed that a new revenue sharing formula be enacted. The proposal, advocated by the governor as a compromise on the long-debated issue, would combine a revenue sharing freeze for the city of Detroit and gradual increases for other local units, and link that to a cut in the Detroit city income tax, which is the highest in the state and considered to be a major obstacle in efforts to revitalize the city.

THE CONTENT OF THE BILLS:

House Bill 5989 would amend the State Revenue Sharing Act to 1) freeze payments to the city of Detroit for 8½ years at current levels; 2) place in statute a new formula, phased in over 8½ years, that weights equally three components, including unit type and population, taxable property value per capita, and yield equalization; and 3) effectively sunset the statutory revenue sharing formula after June 30, 2007. The bill would also rename the act as the "Glenn Steil State Revenue Sharing Act".

Detroit provisions. The bill would specify that, for the period of October 1, 1998 through June 30, 2007, a city with a population of 750,000 or more (the city of Detroit) would receive $333.9 million in total (constitutional plus statutory) revenue sharing payments. Further, the bill specifies that if state sales tax collections decreased from one year to the next, Detroit's revenue sharing payment would also be reduced proportionately.

Counties. Currently, counties receive most of their revenue sharing payments on a per capita basis, and the balance is based on inventory reimbursement payments (based on the 1975 inventory tax base times the current millage rate). The bill would freeze the inventory reimbursement payments at 1997-98 levels and specify that future growth in available revenues would be distributed on a per capita basis. It would increase the current 24.5 percent share of statutory distributions that goes to counties (less inventory replacement payments) to 25.06 percent of the statutory distributions.

Cities, villages, and townships. Cities, villages and townships currently receive 75.5 percent of statutory distributions (less inventory replacement payments), allocated according to the relative tax effort formula. The bill would decrease the share paid to cities, villages, and townships to 74.94 percent of statutory distributions, and eliminate the inventory replacement component. It would replace the relative tax effort formula with a combination of three factors: taxable value per capita, unit type (city, village, or township) and population, and yield equalization. Each of these three components would be given equal weight in calculating a local unit's revenue sharing payment.

• The taxable value per capita component is viewed as a gauge of a community's ability to raise revenue. The bill's formula would weigh each local unit's population by the ratio of statewide taxable value per capita to its local taxable value per capita. The resulting factor would be applied to calculate the localunit's share of 33 1/3 percent of available revenue sharing distributions allocated to cities, villages, and townships.

• The unit type and population component would assign a value to each type of unit (city, village, township) at various population levels. A city would be weighted higher than a village of equal population, and likewise a village would be weighted higher than a township of equal population. However, the bill specifies that certain townships would be assigned the unit type value of a city with the same population under certain circumstances. To be eligible, a township would have to: 1) have a population of 20,000 or more, or 2) have a population of 10,000 or more and provide or make available certain levels of services to its residents, including a) fire services, b) police services on a 24-hour basis either through contractual arrangements or by directly employing personnel, and c) water and sewer services to at least 50 percent of its residents. The population weighting factors would increase by 20 percent after every doubling of the population. Each unit would receive a share of the 33 1/3 percent of statutory distributions allocated to cities, villages, and townships based on its weighted population.

• The yield equalization formula is designed to equalize the amount of per capita total revenue (local plus state) that the local unit collects for each mill it levies. This component recognizes tax effort by equalizing revenue yields for mills actually levied, up to 20 mills. Each unit would receive a share of the 33 1/3 percent of statutory distributions allocated to cities, villages, and townships according to the yield equalization formula.

Phase-in. The bill would phase in the new formulas over an 8½-year period, beginning in fiscal year 1998-99.

Payment increase limitation. The bill would limit the increase in total (constitutional plus statutory) revenue

sharing payments to any local unit to no more than eight percent per year. The bill specifies that any available revenue in excess of the cap would be redistributed to communities that had the lowest increases the previous year. However, the payment limitation would not apply for state fiscal years after the 2000 federal census becomes official to a city, village, or township with a 10 percent or more increase in population.

Hold harmless clause. Beginning in fiscal year 1998-99, the bill specifies that the total (constitutional plus statutory) revenue sharing payments to a city, village, or township could not be less than the total the unit received in the previous year. If necessary to fund this provision, increases to other cities, villages, and townships (based on changes in population, etc.) would be reduced by a uniform percentage.

Special census. The bill would allow a city, village, or township to contract with the secretary of state or the U.S. Census Bureau to conduct a special census of the unit's population, for purposes of computing the population components of the revenue sharing formula.

Repealed sections. The bill would repeal sections of the act that established the bipartisan revenue sharing task force, and sections that contain obsolete provisions.

Sunset. Though the bill would does not specify a sunset date *per se*, it would specify a formula to be used through June 30, 2007, and furthermore, would specify that after that date, revenue sharing would be distributed "as provided by law". [However, the bill contains no language describing a distribution method to be used after that date; further legislative action would be needed to continue the statutory distribution of revenue sharing after that date. Thus, the bill has been described as "sunsetting" the formula.]

House Bill 5391 would amend the City Income Tax Act (MCL 141.503 and 503c) to decrease the maximum city income tax rate that the city of Detroit may levy, as follows:

• Currently a city with a population of more than 1 million can levy an income tax at a rate not more than 3 percent on resident individuals and not more than 1.5 percent on non-resident individuals (and the rate on non-residents can never be more than one-half the rate on residents). The bill would change the population figure to 750,000 and gradually reduce over ten years the maximum rate for residents from 3 percent to 2 percent and the maximum rate on non-residents from 1.5 percent to 1 percent. The 2 percent/1 percent maximums would be for tax years beginning after June 30, 2008. (This provision applies only to the city of Detroit.)

• The rate reduction would be suspended if any three out of four specified conditions existed. In that case, the city could apply to the state administrative board for certification that those conditions existed and the rate reduction would be suspended. (The state administrative board comprises the governor, lieutenant governor, secretary of state, attorney general, state treasurer, and superintendent of public instruction.) The three conditions are:

-- funds had been withdrawn from the city's budget stabilization fund for two or more consecutive city fiscal years or there was a balance of zero in the city's budget stabilization fund;

-- the city's income tax revenue growth was 0.95 or less;

-- the city's local tax base growth was 80 percent or less of the statewide tax base growth rate; and

-- the city's unemployment rate was 10 percent or higher according to the most recent statistics available from the Michigan Jobs Commission.

(The bill contains definitions of the terms "income tax revenue growth rate," "local tax base growth rate", and "statewide tax base growth rate" for the purpose of making the calculations. Those definitions are provided later.)

The rate reduction would be suspended from the date of the state administrative board's certification until the July 1 following the expiration of one year after the certification, unless the city applied for certification that the conditions still existed. Each year the city could apply to the state administrative board for certification of conditions and the certification would continue until the July 1 following the expiration of one year after the board's certification. The certification process could continue each year until the conditions no longer existed.

• If the rate reduction had been suspended, the resident income tax rate for the year in which the rate reduction was again in effect would be the rate in effect on June 30 of that year, reduced by one-tenth of

one percent, and the nonresident rate would be 50 percent of the resident rate.

• The term "income tax revenue growth rate" would mean a number the numerator of which is the income tax collections of the city for the city fiscal year immediately preceding the city's application to the state administrative board for a rate suspension and the denominator of which is the product of the income tax collections for the fiscal year immediately preceding the fiscal year used to determine the numerator multiplied by 1 plus the corresponding change in the average consumer price index for the same period.

The term "local tax base growth rate" would mean the total taxable value of the real property and personal property in the city for the most recent year for which data was available divided by the total taxable value of the real property and personal property in the city for the second year immediately preceding the most recent year for which data was available. The term "statewide tax base growth rate" would be the same calculation made for the state.

Tie-bar. House Bills 5391 and 5989 are tie-barred.

FISCAL IMPLICATIONS:

A representative of the city of Detroit presented testimony to the House Tax Policy Committee that the city income tax reduction, if implemented all at once, would result in a revenue reduction to the city of about $120 million. (12-2-98)

ARGUMENTS:

For:

The legislature faces mounting pressure to make fundamental changes in the statutory revenue sharing formula. The current formula has been dramatically skewed away from the original per capita method of distribution. Many argue that the city of Detroit is unfairly "rewarded" for its high tax burden and receives far more than its fair share of dollars collected from citizens statewide. At the same time, many in the legislature, and the governor, have been reluctant to make devastating cuts to the city's budget just at a time when progress is being made toward economic redevelopment. This proposal attempts to find a middle ground, one that would gradually correct Detroit's over-reliance on revenue sharing and its staggeringly-high income tax, without delivering a sudden huge hit on the city's budget. Growth in revenue sharing funds would be redistributed toward other units of government in a new formula that balances the components of population, tax base, and yield equalization.

For:

One of the factors commonly cited as an obstacle to economic growth in the city of Detroit is the high rate of taxation. Among the most criticized taxes is the city income tax, which is levied on residents and non-residents at a higher rate than in any other city -- three percent for residents and one-and-one-half percent for non-residents. House Bill 5391 would provide for a gradual reduction in the maximum allowable income tax rate. This offers the promise of lower taxes in the future while protecting the city's budget from a sudden dramatic loss of revenue. The bill also contains a mechanism for suspending the tax reduction if economic conditions dictate. Further, Detroit is able to have a higher income tax rate under a provision that refers to "a city with a population of more than 1 million." The bill would lower that figure to 750,000 to avoid complications if the next census puts the city's population at below one million.

Response:

It should be noted that the city could on its own act to reduce its income tax rate; statutory changes are not required. And, though reducing the income tax burden on individuals is a step in the right direction, the proposal would not provide any tax relief to Detroit businesses. Further, some question the effectiveness of an income tax rate cut spread over 10 years, which would be so gradual as to be barely noticeable to taxpayers.

Against:

This revenue sharing proposal falls far short of equity for west Michigan, for townships, for other chronically shortchanged local governments who have long advocated for fairness in the revenue sharing debate. The bill doesn't do enough to move the revenue sharing formula toward a per capita distribution formula, which many see as the only fair way to distribute these funds. Detroit receives about 25 percent of state revenue sharing funds, and has about 11 percent of the state's population. It is perverse to reward Detroit for its high levels of personal and business taxes, which have arguably worsened Detroit's problems by discouraging businesses and individuals from locating there. Cities, villages, and townships that spend money wisely and work to keep taxes low are penalized under the current formula. This proposal would lock in the unfairly high proportion of state revenue sharing payments sent to Detroit, to the detriment of much of the rest of the state.

Against:
On the contrary, a sound argument can be made for keeping intact the current formula that is based on relative tax effort (or instituting more fully some other formula, such as the so-called "yield equalization" proposal, that also recognizes the need for revenue to support necessary services). Shifting revenue sharing dollars toward a per capita distribution formula, as this proposal will do at least in part, will mean great windfalls for many townships, many of which are prosperous and growing. And while growth does result in increased needs for infrastructure and services, an expanding tax base generally allows for growth in services even with a light tax burden. Indeed, Michigan's townships are comparatively affluent, enjoying large fund balances, small millages, and budgets largely supported by state revenue sharing. Simply put, shifting revenue sharing away from urban areas to townships would benefit those who appear to need funds the least, while harming cities' revitalization efforts and encouraging suburban sprawl.

Analyst: D. Martens/C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.