



IN THE RING issue no. 01 | first quarter 2007
 michigan suburbs alliance

A creative prescription for revitalizing Michigan's mature communities through the state shared revenue system

TIME RUNNING OUT FOR REVENUE SHARING

**Critical Funding Formula
 Up for Reauthorization**

For years, state shared revenue has enabled cities to provide essential public services and offer residents attractive, vibrant communities. These funds support core services that residents depend on daily, such as police and fire protection, road and sewer rehabilitation, and garbage collection. Over the past five fiscal years, aggregate revenue sharing losses have exceeded \$1.5 billion, with some cities losing more than 30 percent of their share. These reductions, paired with the increasing costs of providing core services and other revenue limitations, have resulted in drastic service reductions and eliminations, facility closures, and overall fiscal instability in numerous cities across the state. Particularly hard hit are Michigan's older, inner-ring suburbs with their deteriorating infrastructure and relatively static populations. While many city leaders perceive the state's actions as a broken promise that has hamstrung local governments and caused them to make these dramatic cuts, many state legislators view the revenue sharing line item among competing needs within the appropriations process.¹ In June, the current revenue sharing formula will expire, giving state and local leaders an opportunity to redefine the formula and establish a system that fairly recognizes both state and local concerns. This report summarizes the Suburb Alliance's recommendations for a revenue sharing formula that promotes regional cooperation and thriving, stable communities.



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MICHIGAN'S SHARED REVENUE SYSTEM

How It Works

Through revenue sharing, the state redistributes taxes it collects to cities, villages and townships. Revenue sharing began in the 1930s as part of state liquor license tax collections. As the state has levied additional taxes on sales, income and business and restricted cities and other municipalities from collecting local taxes, the program has grown and evolved. The state began sharing sales tax revenue in 1946 after passage of a constitutional amendment. This arrangement was modified in the 1963 state constitution, which mandates that 15 percent of the four percent sales tax collections be returned to local governments.² In 1998, the state Legislature discontinued the practice of sharing business and income tax revenue and enacted a statute sharing an additional 21.3 percent of the original four percent sales tax.³

As a result of this convoluted history, there are two separate sources of shared sales tax revenue: the constitutional requirement (15 percent of the four percent gross collections) and the statutory portion (maximum of 21.3 percent of the four percent gross collections). The constitutional allocation is fixed and allocated on a per-capita basis. Statutory funding, on the other hand, can be adjusted by the governor and Legislature during the budget process. It is distributed by a more complex formula based on four criteria: percent share of fiscal year 1998 statutory

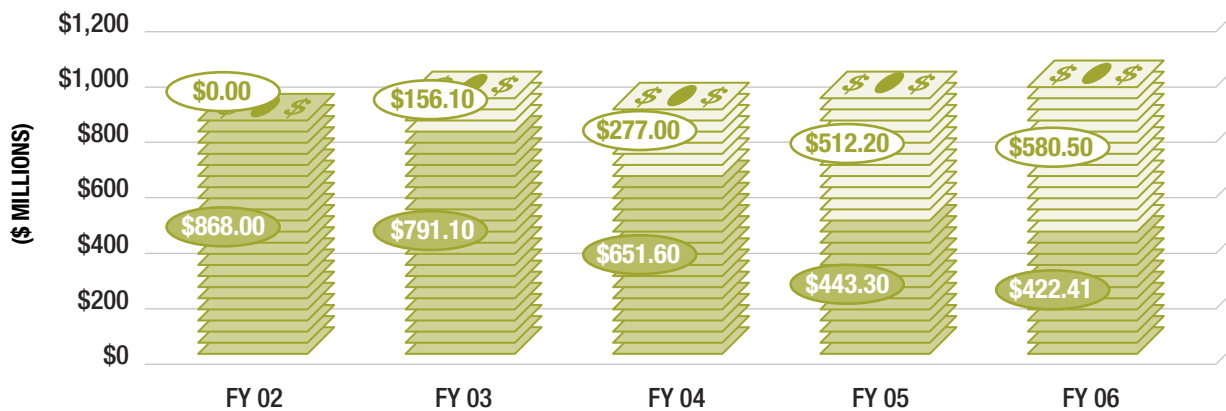
payments, taxable value per capita, population unit type and yield equalization.⁴ According to data from the State Department of Treasury, shared revenue, on average, accounts for 19 percent of a city budget.

Problems With the System

The 21.3 percent of sales tax revenue earmarked by the Legislature in 1998 was only fully shared for one fiscal year before state leaders started to shift portions of that reserve to other parts of the budget. If fully funded, statutory payments in 2006 would have been approximately \$1 billion. Instead, only about \$420 million was allocated. Since 2001, the difference between the statutory maximum and actual payments to local governments has surpassed \$1.5 billion in aggregate.⁵

Statutory revenue sharing was designed to reduce budget disparities between local units of government. The system provides municipalities that struggle to maintain wealth yet have significant infrastructure maintenance costs with sufficient funds to address these challenges. Therefore, reductions in statutory funding hurt cities with established infrastructure, needier populations and below-average property tax bases more severely than other municipalities. Communities experiencing steady growth through residential or commercial development

FIGURE 1: Statutory Revenue Sharing, Payments and Reductions



Source: State Budget Office, Citizens Research Council and the Michigan Municipal League

■ ACTUAL PAYMENT ■ STATUTORY REDUCTION

“The current tax system is no longer appropriate for Michigan’s information- and service-based economy.”

- Final Report of the Task Force on Local Government Services and Fiscal Stability (2006)

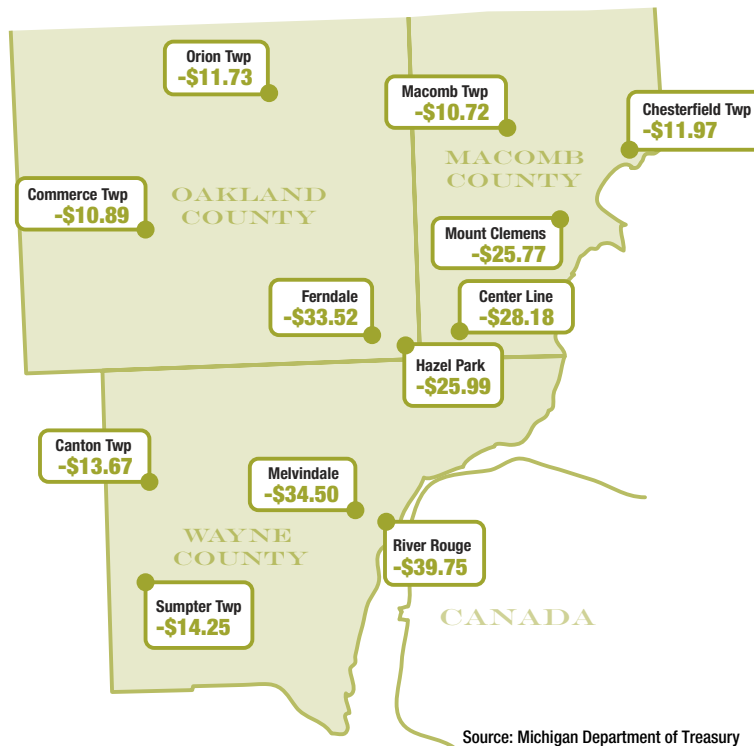
can endure revenue sharing cuts much more easily than built-out cities as funding cuts are mitigated by their increasing tax base. Revenue sharing reductions are felt far more acutely in mature communities such as southeast Michigan’s inner-ring suburbs. As the Governor’s Task Force on Local Government Services and Fiscal Stability report explained, “statutory revenue sharing reductions, effectively, have produced a growing gap between the ‘haves’ and ‘have nots.’”⁶

Refer to the Michigan Municipal League’s white paper, “Communities Count,” for a more detailed explanation of the current revenue sharing system.

An Uncertain Future

The statutory distribution formula is due to expire June 30, 2007. The 15 percent constitutional requirement will remain in place unless the state constitution is amended. Legislative action will be required to determine future payments through the statutory formula. Many experts including state policy makers, local government officials, and scholars have serious doubts about the viability of the current system, even if it were fully funded. In its final report released in June 2006, the Governor’s Task Force on Local Government Services and Fiscal Stability assessed that “the current sales tax system is no longer appropriate for Michigan’s information- and service-based economy. Even with an economic recovery, the sales tax would not keep pace with the increase in costs of government services.”⁷ Clearly, the current formula is inadequately meeting the needs of Michigan’s communities, and it will take creative cooperation from both state and local leaders to develop a system that holds up against the evolving challenges of our various and unique communities. Decision-makers at both levels need to work collaboratively to craft a system that both cultivates stable, thriving communities and acknowledges state budgetary pressures. Undoubtedly, achieving this balance will be challenging, but we can begin postulating alternatives by examining revenue sharing models operating in other states.

FIGURE 2: Total Revenue Sharing Changes Per Capita, Fiscal Year 2002-2006



Source: Michigan Department of Treasury

CHART 1: Percent Change (%)

City of River Rouge	-20.52%
City of Center Line	-18.93%
City of Ferndale	-18.90%
City of Melvindale	-17.97%
City of Mt. Clemens	-17.42%
City of Hazel Park	-16.11%
Sumpter Twp.	-15.40%
Canton Twp.	-14.72%
Chesterfield Twp.	-14.02%
Orion Twp.	-13.87%
Commerce Twp.	-13.50%
Macomb Twp.	-13.34%

CASE STUDIES

Michigan has an opportunity to improve fiscal stability in our cities and to catalyze regional collaboration through a new revenue sharing formula. The debate over what methodology to adopt will be complex, but we have models that we can learn from. Across the country, other states struggle with the same challenges to fund communities that we face here. The approaches they are using or considering could point the way to a successful Michigan policy.

Minnesota System Promotes Equity and Regional Cooperation



Minnesota has the most well-known system of tax-base sharing. Local governments in the seven counties surrounding Minneapolis and Saint Paul contribute 40 percent of the growth in their commercial and industrial property taxes to a regional pool. Dollars from this pool are distributed to 187 local governments using a need-based formula based on per capita property tax values. Communities with the lowest commercial tax capacity receive the most funding from the pool. The Minnesota Citizens League estimates that this

system cuts the gap between rich and poor governments in the region by 80 percent.⁹

This system minimizes to some degree the impact of private sector location decisions and encourages municipal governments to work together to attract investment. However, 60 percent of the growth in tax revenue is kept by the home municipality, so there is still a strong incentive to compete for businesses. In addition, residential property taxes are excluded from the system, so communities that primarily contain private residences are likely not contributing their fair share to the pool.

Arizona Includes Income Tax in Revenue Sharing Base



Arizona shares revenue from both its transaction privilege (sales) tax and income tax with local governments. These two separate systems were established by voter initiatives which simultaneously prohibited local levy of the same taxes. Sales tax is shared with all levels of local government, with 25 percent directed to towns and cities and 40 percent to counties. Fifteen percent of income tax is returned to cities and towns through the Urban Revenue Sharing Fund. Counties do not receive income tax revenue. The

shared percentages of both types of tax have been changed by the state Legislature several times since the programs began.¹⁰

Arizona's Legislature is currently very anti-tax so shared revenues have been threatened repeatedly. Early in 2006, the Senate Finance Committee approved a bill to eliminate revenue sharing with cities that contain over 100,000 people. The full Senate did not adopt the bill but the Legislature has repeatedly cut tax rates over the objections of Arizona cities.

Wisconsin Rewards Service Collaboration and Expenditure Restraints

In 2001, Wisconsin's governor proposed elimination of shared revenue altogether. Instead, payments under three of the state's four revenue sharing programs were suspended (utility payments were maintained) and replaced by a county and municipal aid program that is distributed on a per-capita basis. This new program is subject to the state budget process, distributes fewer total dollars than the previous formula and does not contain any provision for equalizing disparities between wealthy and poor communities. In order to partially compensate for the lower funding levels, the state has initiated several smaller, targeted programs. Of interest are consolidation incentives, which provide \$45 million to localities that have shared service agreements in place, and expenditure restraint incentives, which supply approximately \$60 million to municipalities that limit growth in their

budgets or property tax rates below prescribed levels.⁸

During the debate over reforms, the Wisconsin Alliance of Cities proposed an innovative regional revenue distribution mechanism. County and municipal aid at a given point in time would be frozen as a base. On top of this base, 13 defined regions of the state would share 6.3 percent of the growth in state general revenue. The distribution of the regional pool would be determined by each region's relative contribution to total growth. The actual amount each full-service municipality in a region would receive would be determined by a need index, which likely would be defined by population, tax capacity and/or poverty.



California Proposed Regional Tax Revenue Sharing

In 2002 the California State Assembly approved a bill to establish sales tax revenue sharing in the Sacramento metropolitan region, but the state Senate let the bill die. The proposal called for all sales taxes in the region to be pooled and redistributed based on population, but the bill was later modified to pool only sales tax revenue from new development.

The distribution scheme was also modified to distribute one-third according to population, one-third back to the community where it was collected and the remaining third to the

City, provided it met certain Smart Growth goals. If Sacramento failed to meet the goals, the revenue would have gone to the Sacramento Area Council of Governments for certain regional projects.¹¹



CRAFTING A NEW REVENUE SHARING FORMULA

The revenue sharing models operating in other states present many innovative concepts that could be put to use in Michigan, but before we redefine our own revenue sharing formula, it's critical to identify the values and challenges that define Michigan's communities. Our new revenue sharing formula must take into account these factors and enable our local leaders to achieve vibrant, healthy communities.

Financially Stable Cities

With cities across the state struggling to provide core services, it is clear that the current revenue sharing formula falls far short of fulfilling its primary goals of equalizing revenue among local governments and supplementing communities' tightly curtailed revenue generating capacity. Combined with other structural financing challenges like the interaction between Proposal A and the Headlee Amendment, our revenue sharing formula leaves mature, built-out cities starving for essential resources. It is critical to maintain financially stable cities in order to preserve essential services that residents depend on, such as fire and police protection. An innovative and values-oriented approach to revenue sharing could help bridge the widening gap between the interests of urban and rural communities, as well as address some of the inefficiencies in Michigan's tax structure that are weighing down our cities.

High Quality of Life

By and large, economic prosperity, environmental sustainability and social equity are the measures of a vibrant, attractive community. At the very least, residents expect reliable city services and well-maintained parks and public facilities. Our revenue sharing system needs to support local leaders in their mission to achieve these benchmarks. Currently, revenue sharing functions as general fund dollars, allowing maximum flexibility for their use by local governments. This flexibility is essential to empowering cities, villages and townships to address urgent and ongoing concerns. Maintaining the billions of dollars worth of infrastructure we have already invested in, elevating residents from poverty and empowering local leaders to generate innovative solutions to Michigan's challenges have to be high priorities in our revenue sharing formula.

Regions that Work Together to Achieve Success

Michigan is one of the most governmentally fragmented states in the nation and, inevitably, one of the most interdependent. While our fragmented system offers many benefits like smaller, more accessible governments,

it often results in local interests superseding the welfare of the region. Cities everywhere are facing shrinking revenue streams and struggling to provide municipal services. By working together and sharing resources, local governments can maintain and even improve essential public services like fire and police protection. Currently, the state provides virtually no help to communities working to facilitate joint service delivery. Revenue sharing can serve this purpose. Whether we mimic Wisconsin's incentives for service consolidation, employ regional tax-base sharing like Minnesota, or create an approach of our own, the new revenue sharing system needs to reward multi-community service partnerships and encourage more regional cooperation.



Determining a new revenue sharing strategy will likely be the most significant municipal policy the 2007 Legislature takes up. It is a chance to set the direction for local government finance policy and turn Michigan's local governments into the key players in our economic recovery. First, the traditional purposes of revenue sharing have to be met: create strong communities through equitable funding. Second, it's time to provide incentives for cooperation, breaking down the barriers created by geography and tradition and empowering our regions to meet the challenges presented by a globalizing, service-based economy.

Stabilize and Expand the Revenue Base

Principles

State shared revenue should provide enough support to local governments to preserve basic services and reduce the need for property tax millages. Because these funds support such critical public services, they need to be dependable and predictable for local officials from year to year. As Michigan's industries become more service-based, shared revenue sources should be diversified to reflect the realities of the state's 21st century economy.

Actions:

- Measure local government revenue indicators at the semi-annual state revenue estimating conferences to ensure that shared revenue is stabilizing municipal budgets.
- Expand the sales tax base to include selected services.
- Broaden the statutory formula to include dedicated portions of other locally generated revenue, such as the income tax.

Focus on Equity

Principles

Every Michigan municipality counts on revenue sharing to support core services and capital improvements, but in some communities, the need is significantly stronger. Revenue sharing should be a mechanism to strengthen distressed communities with declining property tax revenue and low-income or shrinking populations. State investment needs to focus on reinvesting in already-established communities with significant infrastructure maintenance costs rather than inefficiently using taxpayer dollars to build new infrastructure in greenfield communities.

Actions:

- Accentuate the weight given to each government unit's taxable value base in the statutory formula while decreasing the importance placed on total population.
- Return "relative tax effort" to the formula (a lot of poorer/larger cities were hurt by its removal in 1998, since they levy so many taxes to pay for their extensive services with a low taxable base).
- Alter the formula to account for the cost of maintaining or improving aging infrastructure in mature communities.

Reward Regional Cooperation

Principles

Cooperation is essential to building more cohesive regions and making more efficient use of limited revenue sharing funds. By distributing revenue regionally in addition to individual communities, the state will encourage neighboring governments to work together to enhance future revenue rather than to compete for tax base. The new revenue sharing formula should also eliminate barriers to intergovernmental collaboration and recognize communities that engage in joint service delivery.

Actions:

- Designate a new fund not subject to the statutory formula that will be used for grants to communities that enact collaborative regional agreements.
- Define characteristics of cohesive regions and distribute shared revenue to those regions to encourage service sharing.
- Authorize regions to develop their own plans, subject to state approval, for the distribution of shared revenue to local units or for regional expenditure of revenue on special projects.

Enhance the Revenue Base with Alternative Revenue Generators

Principles

Local government budgets are extremely vulnerable to state economic downturns, as statutory shared revenue becomes a primary target of state lawmakers in tough budget times. To protect local government services from shifting state priorities, revenue sharing should be backed up by alternative revenue-generating options at the regional level. These options would supplement local budgets and ensure that essential services remain in place.

Actions:

- Authorize regional revenue sharing of a diverse array of locally approved financing options, including:
 - a one percent sales tax;
 - a 0.5 percent personal income tax; or
 - county or regional vehicle registration fees
- Create an exemption to the constitutional 50-mill cap for assessment of a dedicated regional property tax.

8 MINUTES OF ACTIVISM

At the Suburbs Alliance, we completely understand how hectic life gets. Nonetheless, there are important issues that need your support and attention – revenue sharing, for one. We know not everyone can dedicate a lot of time to effecting regional change, so we've developed a call-to-arms for those of you who really want to make a difference, but only have time to think about our pressing regional challenges on the ride home

from work. It's called the 8-Minute Activist, and it identifies concrete actions you can take in eight minutes or less that will have an impact on an issue that affects our region. Look for the 8MA logo to locate 8-Minute Actions you can take to protect revenue sharing. Visit www.suburbsalliance.org for more ways to be an 8-Minute Activist.

TAKE ACTION! What Suburbs Alliance Members Can Do for Revenue Sharing

Corporate Partners:

- Educate the community. Present information on revenue sharing at your next Rotary or Chamber of Commerce meeting. You can contact the Suburbs Alliance for materials, speakers or talking points.
- Facilitate broad-based discussions about Michigan's tax system and possible reforms to simultaneously broaden the revenue base for local governments and meet private sector goals. You can use our policy recommendations on page 7 to stimulate dialogue.

Citizen Advocates:

- **8MA** Make a phone call to your state representative. Tell her or him about the importance of city services to you and your family and explain why the new revenue sharing formula should create incentives for collaborative service agreements that maximize efficiency and quality of public services.
- **8MA** Write a letter to the editor of your local paper. Describe capital improvements that revenue sharing funds and explain the importance of reinvesting in communities with established infrastructure.

Units of Local Government:

- Hold a town hall meeting. Educate community members about revenue sharing by holding open forums where residents can ask questions about revenue sharing and learn how to take action. Refer them to the 8-Minute Activist (above).
- Publish a community newsletter that provides information on revenue sharing. Electronic newsletters are inexpensive and easiest to send, but print might be a better choice for your community. Use other communication mediums as well by making hard copies available at city hall, posting information on your website and broadcasting information on the local cable channel.

Educational Institutions and Nonprofits:

- Host a lecture, seminar, or discussion about revenue sharing. Invite local government leaders, state legislators and community members.
- **8MA** Issue a statement in support of protecting revenue sharing and making it a more dependable revenue source for local governments.

ABOUT THE SERIES

In the Ring is a quarterly series developed by the Michigan Suburbs Alliance to explore cutting-edge policies and practices that support the vitality of the southeast Michigan region and its inner-ring suburbs. The complete series is available online at www.MichiganSuburbsAlliance.org.

ABOUT THE SUBURBS ALLIANCE

The Michigan Suburbs Alliance, a nonprofit organization founded in 2002, is a coalition of cities focused on uniting and strengthening metropolitan Detroit's mature suburbs by elevating regional cooperation, reforming public policies and innovating redevelopment strategies.

NOTES AND RESOURCES

¹ Governor's Task Force on Local Government Services and Fiscal Stability, "Final Report to the Governor." May 2006. p.17. See this report for a detailed history of revenue sharing.

² *ibid*

³ State sales tax was increased to six percent in 1994 but the additional two percent is directed to schools and is not included in revenue sharing calculations.

⁴ For an explanation of these criteria, visit the Michigan Department of Treasury website at <http://michigan.gov/treasury/>

⁵ Governor's Task Force on Local Government Services and Fiscal Stability Report, "Final Report to the Governor." May 2006.

⁶ *ibid* p.16

⁷ *ibid* p.34

⁸ Wisconsin Legislative Fiscal Bureau, "Shared Revenue Program (County and Municipal Aid and Utility Aid)." January 2005.

⁹ The Brookings Institution: Center on Urban Metropolitan Policy. "Valuing America's First Suburbs," 2001.

¹⁰ Arizona Senate Research Staff. "Arizona State Senate Issue Brief: Shared Revenues." October 2006. <http://www.azdor.gov/Newsroom/TaxFacts/2006/0706Taxfact.pdf> and http://www.azleg.gov/briefs/senate/state_percent20shared_percent20revenues.pdf

¹¹ Public Policy Forum. "State Shared Revenue and the Future of Regional Cooperation." Regional Report vol. 1 no. 2. November 2004.

ADDITIONAL RESOURCES

Citizens Research Council of Michigan. "Michigan's Unrestricted Revenue Sharing Program: Retrospect and Prospect." September 2000.

Michigan Municipal League. "Communities Count: Revenue Sharing." May 2006.

Wisconsin Legislative Fiscal Bureau. "Shared Revenue Program (County and Municipal Aid and Utility Aid)." January 2005.

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