FUNDING *for the Future*

Each and every day, the quality of life for Michigan residents is impacted by the choices that local governments make in providing public safety, parks and recreational programming, street and sidewalk repair, and investments into an exciting downtown. These choices define a community and set the stage for whether or not it will be competitive and prosperous in the coming years.

Over the past decade, these choices have become increasingly difficult for local leaders who must operate under a suffocating framework of shrinking funds, rising service costs, and a legacy liability of escalating retiree costs.

Put simply, Michigan's municipal finance structure is broken. It is built on an old economic model for an industrial era. The world has modernized and Michigan must adapt its financial model as well or risk sliding further down the path to financial despair and cultural ruin.

Particularly in light of the recent personal property tax changes, the time is ripe for action. If we expect local leaders to operate efficiently, work regionally, and succeed globally, the state must partner with them and provide the tools to thrive. This includes reevaluating local reliance on property taxes and the dwindling fiscal partnership with the State, and relieving them of legacy burdens carried over from another economic time.

Shrinking Revenues

Most Michigan municipalities have three main revenue streams and each of these is strictly limited. However, there are 22 cities that have elected to levy a city income tax, in most cases to try and mitigate the lack of property tax revenues due to large portions of land being tax exempt.

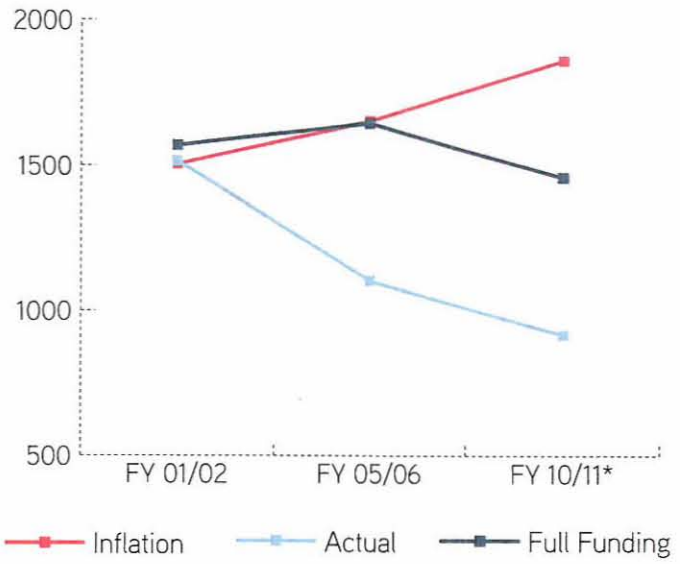
- The vast majority of local revenue comes from property taxes—within one of the most restrictive property tax systems in the country due to the combined effect of the Headlee Amendment and Proposal A. The former limits tax revenues collected by a community as a whole, while the latter limits each parcel's value growth to 5 percent annually or the rate of inflation, whichever is less. The combination of these two constitutional provisions greatly restricts a municipality's ability to raise critical revenue for essential services on pace with rising costs. To make matters even worse, these tax increase caps are set so low it will take decades to restore revenues to the same levels they were prior to the significant decline in property values that has occurred over the last several years. Even if the economy rebounds dramatically and home values rise, the community will not be able to generate any revenues beyond the rate of inflation to respond to growing service needs. Because of the over-reliance on property taxes, when the housing market plummeted, communities suffered significantly.

- The next main stream of revenue is in the form of constitutional and statutory revenue sharing, known currently as EVIP (Economic Vitality and Incentive Program). In 1939, intangible property was removed from the local property tax base and a state intangibles tax was created, with a method put in place to return those funds to locals. Since that time, additional state taxes have been enacted to preempt and replace the local levy, such as sales, income, and single-business taxes. All this was done with the state's pledge that a portion of the revenues raised from the new state taxes would be returned to locals (shared) to provide essential services. Instead, local communities have had their "share" of the funds slashed dramatically in the past ten years and are now being forced to comply with a whole host of new bureaucratic regulations for the privilege of obtaining an ever-decreasing portion of those funds.

- Fees and fines are the third leg of the stool for local revenue generation and even those have been limited by Supreme Court rules. In 1998, the court determined in *Bolt v. City of Lansing* that the city's stormwater fee was a tax that required voter approval under Article 9, Section 31 of the Headlee Amendment. As part of its ruling, the court set out a three-part test for what constitutes a fee: (1) It must serve a valid regulatory purpose, (2) It must be voluntary, and (3) It must be proportional to the service provided to the user paying the fee. Unless a fee meets all three conditions, it is considered a tax and must be voted on. This limitation on fees has been another handcuff on local communities trying to build great places.

TOTAL STATE SHARED REVENUE—CITIES, VILLAGES, TOWNSHIPS, & COUNTIES

Source: The House Fiscal Agency and Plante & Moran



*** Inflation applied to FY 97/98 total state shared revenue based on Proposal A inflation factor 1.6% (98/99), 1.9% (99/00), 3.2% (00/01), 3.2% (01/02), 1.5% (02/03), 2.3% (03/04), 2.3% (04/05), 3.3% (05/06), 3.7% (06/07), 2.3% (07/08), 4.4% (08/09), -.3% (09/10), 2% (10/11)*

The Burden of Legacy Benefits

An additional burden impacting local communities is the growing legacy burden of unfunded retiree benefits in addition to pensions, known as "other post-employment benefits" or OPEB. Rising health care costs, early retirement ages, and a pay-as-you-go approach have created an unsustainable model that has overwhelmed local budgets to the point that many struggle to find enough remaining funds to provide critical services.

According to a recent MSU report, (Funding the Legacy: The Cost of Municipal Workers' Retirement Benefits to Michigan Communities, 2013) the total OPEB liability for Michigan's cities, villages and townships is $13.5 billion with funding levels at only 6 percent. That means that the *net unfunded liability is $12.7 billion.* This is 1.6 times the combined amount owed for unfunded pension obligations ($3.1 billion) and governmental activities debt ($4.7 billion).

Unfortunately, Michigan law does not allow communities to unilaterally or retroactively adjust OPEB, so benefit plans from decades ago are still being provided. The 311 local units which provide OPEB represent 67 percent of Michigan's population. Each contributes an average equivalent of 3.18

mills annually to fund OPEB—or about 20 percent of their general fund revenues. Detroit's OPEB contribution is equivalent to over 35 mills, according to the MSU report.

This legacy liability puts a drain on Michigan's economic hubs that cripples their ability to provide the vital local services that are critical to attract and retain the talent needed to sustain a new economy.

Proposed Policy Actions

In order to fulfill the basic needs for our policy pyramid, we must create financial stability and flexibility. We can accomplish that by implementing the following recommendations:

- Expand the sales tax to services, with a portion dedicated to local governments or added to an improved formula for constitutional revenue sharing. When sales tax structures were being developed, services were a much smaller portion of the economy. Today, however, many economists argue that as the service sector has grown, states and local communities are leaving a significant portion of revenue off the table, while clinging to a model that is continually shrinking. Former Michigan Treasurer and economist Robert Kleine estimates Michigan could be currently leaving nearly $2 billion in sales tax revenue off the books—as much as is currently collected on goods (*New York Times* article "States Seeking Cash Hope to Expand Taxes to Services," May 27, 2011).

- Alternatively, increase the sales tax by one cent and dedicate that new revenue to local governments via a new constitutional revenue sharing formula. Increasing the sales tax by one cent would bring in over $1 billion annually.

- Allow locals to implement land value taxation to encourage appropriate use of space. By shifting where the value is held, some communities could see major improvements in their property development. This tool has been used successfully in targeted cities in other states, like Pennsylvania.

- Revise constitutional revenue sharing for new revenues to reflect service demands as well as population totals. The state needs to be a true partner with local communities to help support the economic strength of our regions. In order to do this, the relationship must deepen beyond an annual appropriations battle that benefits no one. The percentage of shared revenues should be increased or service taxes included, and dedicated to communities based on a combination of population and service provision.

- The existing per capita requirement fails to recognize the massive differences in economic activity and service levels among communities. Michigan should invest its limited resources wisely and invest in the places where the economy can grow. The focus must be on the places which will lead to economic prosperity—that metric is not defined by simply the number of households.

- Advocate for the creation of an optional State OPEB Pool, which would be bonded. Local communities could select to have their OPEB liability assumed by the pool and would make payments therein.

The Partnership for Place plan advances new ways to end a decade of funding cuts to Michigan cities and protects future funding for local services from raids by the Legislature.

Excerpt from the League's "Partnership for Place: An Agenda for a Competitive 21st Century Michigan," 2013.

Mt. Pleasant City Manager to Lead Executive Search Service

Outgoing Mt. Pleasant City Manager Kathie Grinzinger has been selected to lead the League's Executive Search Service. In this role, Grinzinger will assist Michigan communities with their executive searches by connecting talented public administrators to key leadership positions.

Grinzinger will leave her Mt. Pleasant city manager's position at the end of 2013 and begin her new League role on February 1, 2014. Grinzinger brings with her more than 30-years experience in municipal management and public sector human resources.

The League has been assisting Michigan's communities in finding effective leaders for nearly 20 years, and has led hundreds of successful matches between public sector executives and communities.

Grinzinger said her new role with the League will allow her to continue to work with Michigan communities and managers. "It's really the best of both worlds–I'll be able to continue to use my administrative and human resource skills while also helping improve Michigan communities. I'm excited and looking forward to helping Michigan communities find their leaders and managers to guide them into the future."