Towards Fiscally Healthy Michigan Local Governments

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The state of Michigan has long incubated financial stress among its localities. Though not the state's intention, limits on local governments' ability to raise revenues, coupled with reduced state aid, have decimated local budgets. Additionally, local government fragmentation often breeds inefficiencies, further exacerbating local fiscal distress throughout Michigan.

The state has significantly underfunded its statutory revenue sharing for the past two decades: since the early 2000s, repeated cuts in funding, combined with changes to criteria for receiving statutory revenue, have resulted in an overall loss of needed funding for local governments. At the same time, Michigan has some of the tightest property tax limits in the United States. These limits' unusual design contributed to large declines in property tax revenue both during and since the Great Recession, with long-lasting impacts on localities' ability to pay for essential public services. As in many states, local governments in Michigan rely heavily on property taxes to fund their operations; however, Michigan's limitations on property taxes severely curb local governments' ability to raise revenues necessary for critical local services such as road upkeep, fire protection, and public education.

Because localities are further prohibited from collecting a variety of other taxes and fees that could bolster revenues, the resulting lack of revenue diversity also hinders local governments' ability to adapt to changing economic conditions, including the COVID-19 crisis. Finally, the state suffers from government fragmentation, which results in inefficiencies: with every county, city, village, township, and special district responsible for providing certain services, duplications among overlying governments may arise. Cost-saving measures implemented by many municipalities can only go so far and opportunities for collaboration may be overlooked.

With dwindling state aid, strict limitations on property taxes, few local revenue options, and local government fragmentation, it is unsurprising that many of Michigan's local governments are fiscally distressed. The limited options available for addressing fiscal stress affect Michigan residents' access to opportunity and their overall quality of life. With fewer total state dollars available to localities, important programs—like capital investment, infrastructure maintenance, economic development, affordable housing, and more—take a hit, often falling short of meeting residents' needs.

The American Society of Civil Engineers gave the state an overall grade of D+ for its infrastructure (ASCE 2018). Based on a 2016 assessment, 39 percent of Michigan's 120,000 miles of paved roadways are rated in poor condition. Safe and well-maintained roads provide residents access to work, home, medical facilities, schools, and businesses and also reduce fatalities due to accidents. The stormwater management systems in the state are also deficient; during heavy rains, poorly maintained combined sewer systems back up and discharge untreated wastewater into lakes and rivers. The lack of maintenance also makes homes more susceptible to flooding and water shutoffs, which has serious implications for residents' quality of life.

Often, local fiscal stress in Michigan is worse in areas where concentrations of minorities reside and where extreme poverty is prevalent. For example, Benton Harbor is a small city with a high poverty rate and a predominantly African American population. The city has been unable to maintain its water infrastructure, leading to water shutoffs, increased water rates for customers, and lead contamination of drinking water. In 2014, Benton Harbor residents paid $3.80 per 100 cubic feet (ccf) of municipal drinking water, yet in a neighboring city, St. Joseph, residents—who are predominantly white—paid just $1.80 per ccf (Bye et al. 2017; U.S. Census 2010).

Michigan's businesses also suffer from inadequate investments in local governments. Residents leave Michigan because they want to live and work in communities that provide the amenities and services that make their lives better—and thus, too many of Michigan's localities fail their residents by design. Between 2010 and 2019, Michigan lost a net 59,000 residents, according to an analysis of Census data (PRB 2020).

The Great Recession worsened fiscal hardship for many municipalities across the state, but the vast majority of problems these cities face are structural, not just the result of short-term economic distress. In addition, localities across the country now face severe and unprecedented fiscal challenges as a result of the COVID-19 pandemic. With 70 percent of cities nationwide not receiving any CARES Act funding, many have delayed or canceled capital expenditures and infrastructure projects, cut community and economic development programs, and furloughed or eliminated city staff positions—pulling back from the very activities that normally contribute to economic growth and stability, which in turn, affect residents' quality of life.

In addition, most direct federal assistance and aid for cities is only accessible to the largest metropolitan areas, depriving less populated cities of federal dollars. Smaller cities hit hard by the Great Recession, including many in Michigan, missed out on crucial assistance and continue to face fiscal challenges. Unlike the federal government, local governments cannot operate with budget deficits, leaving them no choice but to drastically cut spending or raise taxes—and Michigan's localities are already limited on the latter. Michigan communities have thus been particularly vulnerable to the fiscal impacts of COVID-19, which has exacerbated the same financial conditions they have struggled with for years.

By taking key steps to give localities greater fiscal autonomy and budgetary control, however, Michigan policy makers can give communities a fighting chance to recover from the current crisis—and to better prepare for the next one.

This report offers several recommendations related to each of the aforementioned challenges. The most politically feasible approach is to couple one or two recommendations that increase local revenues with one recommendation that addresses local government fragmentation (which ultimately gets at cost savings). State officials must remember that local governments provide the services and infrastructure on which residents and businesses rely; implementing policies that make it easier for local governments to do their job ultimately benefits the state of Michigan as a whole and the people and businesses that comprise it.

State Aid

While constitutional revenue sharing is guaranteed under the state constitution, statutory revenue sharing has been significantly underfunded for the past two decades. Furthermore, statutory revenue sharing was eliminated for almost 1,300 cities, villages, and townships in Michigan between Fiscal Year 2005 and Fiscal Year 2010 due to funding cuts and changes in distribution formulas. Statutory revenue sharing was 58 percent of total revenue sharing in 1998, but it declined to just 23 percent by 2012. Since then, it has remained between 23 and 25 percent of total revenue sharing, a shift with major implications for the distribution of revenue sharing to municipalities around the state.

One key recommendation from this report is that Michigan create a special state fund to distribute state aid to local governments. The majority of states that earmark a percentage of state sales or income taxes for local governments have this type of special fund (Kass, Pagano, and Omeyr 2020). For example, there is the Revenue-Sharing Account in Idaho, the Local Government Tax Distribution Account in Nevada, and the Local Government Fund in Ohio. A special state fund in Michigan would help protect localities from cuts in state revenue sharing by reinforcing that the funds are set aside for local governments under state law and should not be subject to the state budget appropriations process.

The state could further ensure statutory revenue sharing is fully funded by increasing the sales tax rate or by increasing a state-level tax that boosts its own revenues, such that the state does not need to dip into the sales tax revenues meant for local governments. Increasing the sales tax is a viable option: looking only at state-level taxes, Michigan's sales tax rate ranks in the middle compared to other states, but after accounting for state *and* local sales taxes, Michigan ranks near the bottom because it does not allow local sales taxes.

Property Tax Limits

While overall reliance on property taxes in Michigan is close to the national average, the property tax is particularly important for local governments' fiscal health in Michigan because they have little access to other types of taxes to raise revenue. Excluding property taxes, local governments in Michigan raised only 2 percent of their general revenues from other taxes, compared to 11 percent for localities in the United States as a whole. State aid and user charges are both essential components of local governments' revenue mix and have important strengths. However, they also have limits: state aid is often cut during recessions, as we saw in the Great Recession and are seeing now with the pandemic, and charges are generally earmarked to fund specific services, restricting local governments' ability to use them to fund other programs (Yuan et al. 2009). This highlights the need for greater local control of the property tax.

Michigan is unique in the restrictiveness of the state's property tax limits: states typically use one of three main types of property tax limits, but Michigan uses all three (Sands and Skidmore 2015; Significant Features of the Property Tax 2020). These include a complicated set of rate limits, a tight assessment limit (implemented through Proposal A), and a strict levy limit (implemented via the Headlee Amendment).

The assessment limit and levy limit both restrict annual increases to the rate of inflation, which is lower than most other states' restrictions. Three studies comparing the restrictiveness of sates' property tax limits have ranked Michigan either second- or sixth-most restrictive (Amiel, Deller, and Stallmann 2009; Park, Park, and Maher 2018; Wen at al. 2020).

Michigan's levy limit is very unusual. Ordinarily, levy limits simply restrict annual increases in a jurisdiction's property tax collections, often with exclusions for new development and debt service. In effect, these levy limits are operationalized in most states by requiring local governments to adjust their mill rates when the property tax base increases rapidly, but state laws rarely explicitly mention rate adjustments. As a result, if the property tax base grows slowly or declines, local governments can raise their mill rates as long as their total collections do not grow faster than the state's levy limit permits. In contrast, Michigan's levy limit requires reductions in mill rates when the property tax base grows rapidly ("Headlee rollbacks") but prohibits increases in mill rates without an override vote when the property tax base grows slowly or declines. Michigan jurisdictions used to have flexibility to raise their mill rates in these situations, but the ability to use tax rate "rollups" was eliminated around 1994 in connection with Proposal A school funding reforms. A survey of property tax experts in 21 states with the tightest levy limits in the country found that, unlike Michigan, nearly every other state enables local governments to raise mill rates when the property tax base grows slowly or declines.

One key recommendation from this report is that Michigan should allow its local governments to raise mill rates without an override vote when the tax base grows slowly. Further, the current levy limit erodes the stability of the property tax, and, as such, this report recommends that Michigan reauthorize tax rate rollups.

Local Revenue Options

While every level of government can levy property taxes, other taxes and fees are largely not allowed in Michigan. Historically, Michigan state officials were concerned about the potential burden of the property tax on residents and businesses, which resulted in the strict property tax limits identified above. However, allowing local diversification of revenue sources would make localities less reliant on property taxes (and state aid).

Revenue diversification has consistently been proven a determinant of local fiscal stability. One group of researchers analyzed the financing of the United States' largest central cities from 1997 to 2008 and found that more diversified revenue structures generate more revenues than ones that rely primarily on the property tax (Chernick, Langley, and Reschovsky 2011). Researchers who analyzed Georgia and Florida counties further found that more diversified revenue structures tend to produce more stable revenues (Taeseop Yoon et al. 2013; Yan 2008).

In the past several years, many states have passed legislation enabling municipalities to collect local taxes. For example, in 2013, Minnesota authorized all its counties to impose a fee on vehicles registered in that county; previously, only the metropolitan Twin Cities counties could impose such a fee (Transportation for America 2014). The fees fund county highway projects.

More local taxes would likely exacerbate fiscal disparities among Michigan jurisdictions, however, because municipalities with low existing revenue-raising capacity often lack the tax bases for new local option taxes in the first place. One important recommendation in this report is therefore that counties in Michigan be given the authority to levy and collect a new tax or fee. One of two approaches should follow: (1) reorganize the local government's service delivery model to allow counties to provide more services; or (2) create a system for the county to distribute new revenues to all local units of government within the county, with the county retaining a small portion of the revenues to cover administrative costs and to help pay for other county-provided services.

The benefits of the first option are that cities, villages, and townships can free up some funds for other services or investments, and the counties will be able to provide some services at economies of scale with the new revenue they collect. The benefit of the second option is that all cities, villages, townships, and counties have a new source of revenue that can either be earmarked for a certain type of expenditure need (such as infrastructure improvements) or deposited into general funds and used as local governments see fit.

The state should allow counties to determine what new tax or fee would work best in their own jurisdictions, taking into consideration how equitable the new tax should be and what the revenue will be used to fund. For example, the parts of Michigan that rely heavily on tourism would benefit from shifting the tax burden to visitors, whereas other areas would need to take different approaches.

Government Fragmentation and Inefficiencies

Michigan has 83 counties, 276 cities, 257 villages, over 1,200 townships, and over one thousand special purpose districts, each responsible for providing certain services. According to the 2017 Census of Governments, Michigan ranks 12th among the 50 states in terms of its total number of local governments (combining general and special purpose governments). Several Michigan municipalities have implemented cost-saving measures like cooperative agreements, but these measures can only preserve so much revenue on an individual basis. Duplication still occurs in some places, as overlying governments provide competing rather than combined services. Inefficiencies are also inevitable; adjacent localities may miss opportunities for collaboration.

Because of the potential pitfalls of blanket consolidation, we recommend instead two possible approaches: networked enterprise and government as a platform. In a networked enterprise, local government connects public, private, and nonprofit resources in the pursuit of a shared objective, such as reducing poverty or improving high school graduation rates. In the government as a platform model, the local government acts as a coordinator by “plugging in” the most effective service providers of basic public services, regardless of whether the provider is a private business, nonprofit, or another entity. Both models are meant to be initiated by the local governments themselves, but the state can take certain actions to make either easier for localities to implement.

Conclusion

Many of Michigan’s local governments were headed for fiscal distress long before COVID-19, and the pandemic has unfortunately only sped up the inevitable. Over the past few decades, the state government has implemented so many barriers for localities to achieve fiscal stability that Michigan’s counties, cities, townships, and villages could not adequately prepare for or recover from a crisis. It is time for state leaders to take concerted efforts to improve the fiscal health of local governments in Michigan, for the sake of local taxpayers and businesses—all residents of Michigan, on whom the state cannot turn its back.

This report details several recommendations for Michigan to implement and bolster the fiscal health of its local governments. Improving state aid would likely be the quickest and most impactful recommendation to implement, would put more dollars to work for the residents of Michigan, and would likely have the most visible impact. Relieving some of the property tax limitations or authorizing an additional local revenue source would, over time, also improve the capacity and stability of local governments’ budgets. Efforts to address inefficiencies at the local level will take time, but such efforts should be coupled with at least one of the above recommendations that addresses revenue. Tackling local fiscal distress will be politically feasible with a multipronged approach that aims to improve revenues but also reduce costs.

Towards Fiscally Healthy Michigan Local Governments

Fiscal Pressures Facing Michigan's Localities

Historically, the state of Michigan has incubated financial stress among its local governments. Though hardly the state's intention, this stress stems largely from how the state limits local governments' ability to raise revenues—while at the same time providing less and less aid to its localities (Sapotichne et al. 2015). Additionally, local government fragmentation often breeds inefficiencies, further exacerbating the fiscal health of localities in Michigan.

Statutory revenue sharing in Michigan has been significantly underfunded for the past two decades: since the early 2000s, repeated cuts in funding amounts combined with changes to criteria for receiving statutory revenue have resulted in an overall loss of needed funding for local governments. At the same time, Michigan has some of the tightest property tax limits in the country, and this unusual design has contributed to large declines in property tax revenue both during and after the Great Recession, with long-lasting impacts on the ability of localities to pay for essential public services.

Because localities are further prohibited from collecting a variety of other taxes and fees that could bolster revenues from the property tax, the lack of revenue diversity also hinders local governments' ability to adapt to changing economic conditions, such as the COVID-19 pandemic. Finally, the state suffers from excessive government fragmentation, which results in inefficiencies: With each county, city, village, township, and special district responsible for providing certain services, duplications among overlying governments are common, and cost-saving measures implemented by some municipalities can only go so far.

With dwindling state aid, strict limitations on property taxes, few local options for revenue sources, and local government fragmentation, many of Michigan's local governments are bound to be fiscally distressed. These limited options for addressing fiscal stress affect Michigan residents' access to opportunity and overall quality of life. Capital programs, infrastructure maintenance, economic development, affordable housing, and other important local programs suffer, often falling short of meeting residents' needs.

The American Society of Civil Engineers even gave the state an overall grade of D+ for its infrastructure (ASCE 2018). Based on a 2016 assessment, 39 percent of Michigan's 120,000 miles of paved roadways are rated in poor condition. Safe and well-maintained roads provide residents access to work, home, medical facilities, schools, and businesses and also reduce fatalities due to accidents. The stormwater management systems in the state are also deficient: not enough is being done to maintain combined sewer overflows, where heavy rains cause backups in the system and results in the discharge of untreated wastewater into freshwater bodies. This has implications for residents' quality of life, especially in terms of how susceptible their homes are to flooding and water shutoffs.

Often, local fiscal stress in Michigan is worse in areas where concentrations of minorities reside and where extreme poverty is prevalent. For example, Benton Harbor is a small city with a high poverty rate and a predominantly African-American population. The city has been unable to maintain its water infrastructure, leading to water shutoffs, increased water rates for customers, and lead contamination of drinking water. In 2014, Benton Harbor residents paid $3.80 per 100 cubic feet (ccf) of municipal drinking water, yet in a neighboring city, St. Joseph, residents—who were predominantly white—paid just $1.80 per ccf (Bye et al. 2017; U.S. Census 2010).

Michigan's businesses also suffer from these inadequate investments. Residents leave Michigan because they want to live and work in communities that provide the resources and investments that make residents' lives better—and thus, too many of Michigan's localities fail their residents by design. Using data from the U.S. Census Bureau, the Population Reference Bureau estimated that between 2010 and 2019 Michigan had a net migration loss of 59,000. Only six other states lost more population than that. Using a different measure of migration—IRS data—the Cato Institute estimated that Michigan was among the top 10 states with the largest net migration losses in 2016 (Edwards 2018). The approximately 10,325 residents who migrated out of Michigan that year equates to a loss of $711 million in aggregate household income (and the income tax is an important revenue source for cities in Michigan).

Michigan's economic downturn during the Great Recession worsened fiscal hardship for many municipalities across the state, but the vast majority of problems these places face are structural, not simply the result of short-term economic distress. In the years following the Great Recession, for instance, 17 local governments and school districts operated under the control of a state-appointed emergency financial manager (Sapotichne et al. 2015). More importantly, jurisdictions that have been under emergency management have tended to be areas with concentrations of poverty and areas whose residents predominantly identify as African-American (Lee et al. 2016; Lewis 2013). This does not mean that Michigan local governments are prone to mismanagement; rather, it demonstrates that they are generally less equipped to weather the impacts of fiscal crises because of the limitations placed on them by the state.

Furthermore, the state lacks a dedicated state agency or department whose mission it is to support local governments in achieving fiscal health with guidance, training, and oversight. Many other states—including Massachusetts, Alaska, and Colorado—have such a department within their executive branches. Today, Michigan local governments' recovery from the latest financial crisis depends on whether the state takes action to give localities greater fiscal autonomy and budgetary control and provides local governments with the resources to successfully address inefficiencies.

This report offers several recommendations related to each of the aforementioned problems. The most feasible approach is to couple one or two recommendations that increase local revenues with one recommendation that addresses local government fragmentation (which ultimately gets at cost savings). State officials must remember that local governments provide the services and infrastructure on which residents and businesses rely; implementing policies that make it easier for local governments to do their job ultimately benefits the state of Michigan as a whole.

Expected Revenue Declines for Michigan Cities Related to COVID-19

In addition to fiscal challenges both before and after the Great Recession, localities across the country already face severe and unprecedented fiscal challenges as a result of the COVID-19 pandemic. Nationally, cities are at the mercy of federal and state governments for financial assistance to support increased costs for public health and emergency response; to provide aid to individuals, families, and businesses struggling to remain fiscally solvent as the pandemic continues; and to alleviate local government budget pressures due to declining own-source revenues so that service delivery is not compromised. All of these problems put the health, safety, and welfare of Michigan's residents in jeopardy.

Despite federal aid packages such as the CARES Act that contain resources for states to disburse to municipalities, many cities across the country are already facing and will continue to face severe challenges in response to these broader economic conditions. U.S. cities are projected to experience a $360 billion collective revenue loss over the next three years, and, according to the National League of Cities' most recent survey, 74 percent of cities have already been forced to make budget cuts and adjustments (Yadavalli et al. 2020). With 70 percent of cities nationwide not receiving CARES Act funding at all, many are delaying or canceling capital expenditures and infrastructure projects, cutting community and economic development programs, and furloughing and eliminating city staff positions—all of which normally contribute to economic growth and stability (McFarland and Rivett 2020; NLC 2020a).

In addition, most available direct federal assistance and aid for cities is only accessible to the largest metropolitan areas, depriving less populated cities of federal dollars. This means that many smaller cities hit hard by the Great Recession, including many in Michigan, will miss out on crucial assistance and continue to face ongoing fiscal challenges. Unlike the federal government, local governments cannot operate with budget deficits, leaving them no choice but to drastically cut spending or raise taxes. A tax increase to cover general local government costs would likely be met with opposition from residents, forcing localities to rely heavily on spending cuts to balance the budget.

These nationwide impacts trickled down to Michigan just as many cities were beginning to see revenues return to pre-recession levels in the last few years. Cities in Michigan that rely on income taxes as a source of revenue (including Detroit, Grand Rapids, and 22 others) will start to see revenue reductions on that front immediately. Property taxes, which provide the vast majority of most Michigan cities' general funds, are also likely to fall, though the impact on city coffers will be delayed because of the timing of payments. Revenue sharing from the state will decline quickly, too, as collections from its source—the state sales tax—will also drop dramatically.

In response, Michigan's cities are taking drastic measures to balance budgets and prepare for extreme cuts to programs and essential services. Detroit, for instance, is anticipating a $348 million deficit over the next 16 months, and even smaller cities, such as Grand Rapids and Saginaw, must anticipate steep declines in local income taxes that comprise a portion of their general funds. Other communities, such as Battle Creek, Jackson, and Alpena, are further cutting budgets and anticipating major layoffs. Further, budget cuts are often made in an inequitable way, disproportionally affecting minority and impoverished residents. For example, one study found that reductions in school spending during the Great Recession led to a small decline in test scores, with a wider score gap between the high- and low-poverty districts (Jackson et al. 2018).

The breadth and depth of these cuts suggest that Michigan communities were unprepared for this type of severe economic downturn, and experts predict that the current crisis will have a larger impact on Michigan's economy and fiscal health than the Great Recession. By taking key steps to give localities greater fiscal autonomy and budgetary control, however, Michigan policy makers can give localities a fighting chance to recover from the current crisis—and to better prepare for the next one.

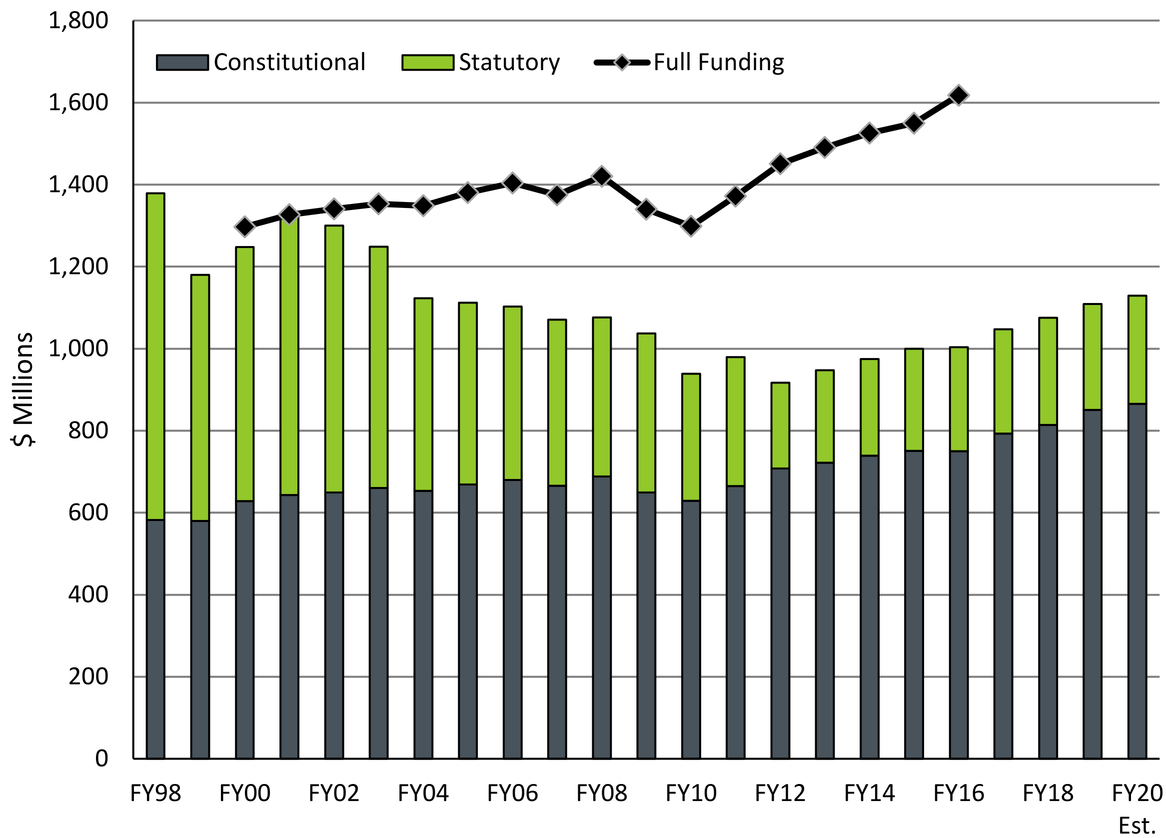
State Aid

Background

Large cuts in state revenue sharing are one of the biggest factors driving fiscal distress in many Michigan localities, especially in poorer communities that have experienced significant population declines. In Michigan, revenue sharing falls into two broad categories: constitutional and statutory. Constitutional revenue sharing requires 15 percent of collections from the 4 percent portion of the state's 6 percent sales tax be distributed to all cities, villages, and townships (CVTs) on a per capita basis; statutory revenue sharing (per Public Act 532 of 1998) requires an additional 21.3 percent of collections from the 4 percent portion of the sales tax be distributed to counties and CVTs. Statutory revenue sharing is distributed through a formula "designed to compensate for the significant variation in local governments' service delivery needs, infrastructure maintenance requirements, and capacity to generate local tax revenue" (Michigan Municipal League 2019, 3).

While constitutional revenue sharing is guaranteed under the state constitution, statutory revenue sharing has been significantly underfunded for the past two decades. Figure 1 shows that statutory revenue sharing fell from $797 million in FY1998 to $209 million in FY2012. It has since grown slightly to $264 million in FY2020.

Figure 1: Revenue Sharing to Cities, Villages, and Towns (FY1998–FY2020)



Sources: Michigan Senate Fiscal Agency (2016, 2019); Michigan Municipal League (2017).

There have been many changes to statutory revenue sharing since the 1998 passage of Public Act 532. Between FY2005 and FY2010, funding cuts and changes in distribution formulas eliminated statutory revenue sharing for almost 1,300 cities, villages, and townships. In FY2012, the Economic Vitality and Incentive Program (EVIP) made statutory revenue sharing contingent on meeting a range of criteria, and further funding cuts resulted in even fewer localities receiving EVIP payments. By FY2015, most EVIP requirements were dropped, except for those on accountability and transparency, and the program's name was changed to CVT Revenue Sharing. Since then, there have been modest increases in funding and the number of jurisdictions eligible for CVT Revenue Sharing (Michigan House Fiscal Agency 2019).

Full funding for constitutional revenue sharing, combined with large cuts to statutory revenue sharing, resulted in statutory revenue sharing's decline from 58 percent of total revenue sharing in 1998 to just 23 percent in 2012. Since 2012, statutory revenue sharing has remained between 23 and 25 percent of total revenue sharing, a shift with major implications for the distribution of revenue sharing to municipalities around the state. Whereas statutory revenue sharing is designed to provide relatively more aid to fiscally distressed jurisdictions, constitutional revenue sharing is distributed on a per capita basis. Thus cities, villages, and townships will receive more aid as their populations grow and vice versa. For example, the Michigan Senate Fiscal Agency (2016) looked at changes in revenue sharing for all 1,773 cities, villages, and townships from FY2003 to FY2014. As Table 1 shows, CVTs with larger population declines experienced the largest cuts in revenue sharing, whereas those with population growth benefited from increases in revenue sharing. Ninety CVTs faced revenue sharing cuts exceeding 30 percent, with these jurisdictions also struggling with population declines averaging 16.3 percent.

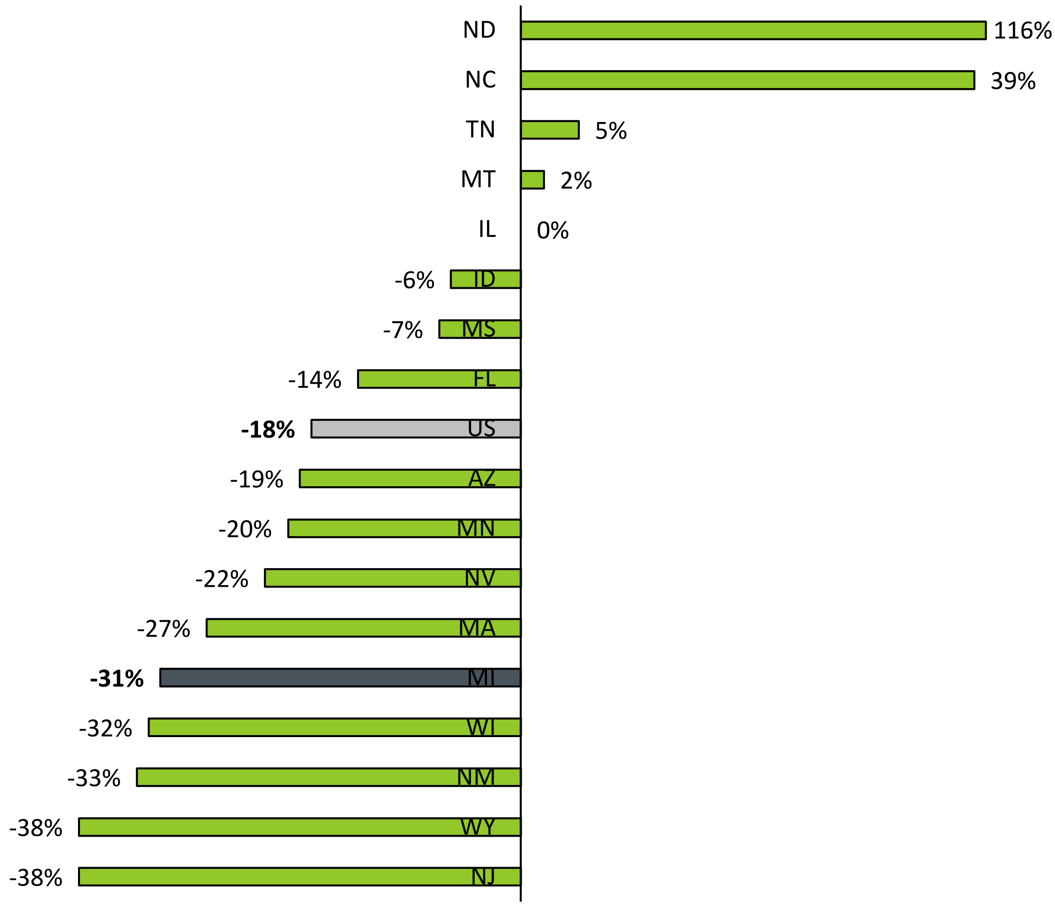
Table 1: Changes in Revenue Sharing and Population (FY2003–FY2014)

Revenue Sharing (% Chg. FY2003 to FY2014)	Average Population Change	Number of CVTs
30%+ Decrease	-16.3%	90
20–29% Decrease	-5.2%	340
10–19% Decrease	-3.5%	336
0.1–9% Decrease	-0.3%	472
0–9% Increase	6.0%	332
10%+ Increase	21.6%	203

Source: Michigan Senate Fiscal Agency (2016).

While many states cut aid to local governments during and after the Great Recession, Michigan's cuts were considerably larger than those in most other states. Figure 2 shows that from 2007 to 2017, per capita unrestricted state aid for municipalities declined 31 percent in Michigan after accounting for inflation—far higher than the 18 percent decline nationwide (U.S. Census Bureau 2017a). Michigan also had the fifth-largest drop in unrestricted state aid for municipalities out of 17 states where unrestricted aid accounted for at least 5 percent of municipal general revenues.

Figure 2: Real Per Capita Unrestricted State Aid to Municipalities, Percent Change 2007–2017



Source: U.S. Census Bureau (2017a).
Note: Figure 2 shows Census data on state "general support," a category that includes both revenue sharing and general aid programs, but not restricted aid programs earmarked for specific purposes. It includes states where state general support accounted for at least 5 percent of municipal general revenues in 2017.

As shown in Figure 2, state aid to municipalities fell in most states between 2007 and 2017. See Appendix 1 for actual dollar amounts and unrestricted state aid as a percent of general revenue. In states that share revenue by earmarking a percentage of state taxes for local aid, however, these declines seem driven mainly by significant drops in state sales and income taxes during this period, which meant equivalent drops in revenue sharing under state law.

Policy changes to reduce the percentage of state tax revenues shared via tax earmarking, as in Michigan, appear to be uncommon nationally, although evidence is limited. For example, one study looked at seven states that provide significant aid to municipalities using tax earmarking, and none enacted policy changes that specifically reduced aid to local governments in the past two decades (Kass, Pagano, and Omeyr 2020).[1] There were a few instances, however, in which

[1] In Arizona, state income tax rates were cut in 2007 and 2008, which reduced the amount of revenue shared with local governments; however, there was no change to the percentage of state taxes shared.

states reduced the portion of revenue earmarked to local governments when state tax rates were increased to ensure that the state government captured all additional revenue generated from the higher rates.[2] See Appendix 2 for a breakdown of how Michigan compares to other states that share sales tax revenue with municipalities. In fact, North Carolina passed legislation in 2015 that significantly *increased* state revenue sharing. Prior to the 2015 reform, the state shared revenue from multiple taxes, but state government retained the portion of electricity sales tax revenue that was supposed to have gone to local governments, which would otherwise have accounted for the majority of revenue shared with localities. Under the 2015 law, the state stopped retaining electricity sales tax revenue that was earmarked for municipalities.[3] As a result, North Carolina had the second-largest increase in per capita unrestricted state aid to municipalities in the country from 2007 to 2017 (Kass, Pagano, and Omeyr 2020).

Recommendations to Reform Michigan's Revenue Sharing

Fully funding revenue sharing is essential to promoting the fiscal resilience of local governments in Michigan—especially given the state's tight property tax limits and restrictions on local tax authority. More revenues for local governments would allow localities to improve upon services and invest in infrastructure that ultimately benefit residents.

Fully fund statutory revenue sharing

Fully funding statutory revenue sharing would greatly help local governments provide the public services essential for improving quality of life and economic competitiveness in Michigan. In order to do so, Michigan could increase the sales tax rate and share resulting revenues with local governments. Looking only at state-level taxes, Michigan's sales tax rate ranks in the middle compared to other states, but after accounting for state and local sales taxes Michigan ranks near the bottom because it does not allow local sales taxes (Tax Foundation 2020).

Alternatively, the state could increase a state-level tax to boost its own revenues so that it does not need to dip into the sales tax revenues meant for the local governments. In FY2018, the state corporate income tax netted Michigan only about $110 per capita, which is lower than 31 of the 45 states that collect this tax (Tax Foundation 2020). Michigan also has one of the lowest excise tax rates on recreational marijuana compared to the other states that collect such a tax (Tax Foundation 2020). See Appendix 3 for a breakdown of how Michigan's state-level taxes compare to other states. Additionally, the National Conference of State Legislatures maintains a database that chronicles all state tax actions. Recent examples of state tax increases include:

- Alabama increased motor fuel tax rates by six cents.
- Arkansas increased 911 system fees from $0.65 to $1.30.
- Colorado now levies a 10 percent tax on net sports betting proceeds after voters approved to decriminalize sports betting.

Similarly, Tennessee passed legislation in 2015 phasing out the Hall Income Tax, one of seven different taxes that the state shares with municipalities as unrestricted aid.

[2] When Illinois temporarily increased state income tax rates in 2011, the state reduced the percentage of income taxes shared with local governments, so local governments did not benefit from the tax rate increases. However, that legislation was not meant to cut local revenue sharing but rather to avoid an increase.

[3] Similarly, Tennessee passed legislation in 2009 and 2010 that allowed new entities to supply wholesale electricity and required them to make payments in lieu of taxes that would then increase state aid from the gross receipts tax.

- Connecticut increased excise tax rates for alcoholic beverages (except beer) by 10 percent.
- New Mexico increased the motor vehicle excise tax rate from 3 to 4 percent.
- Ohio increased motor fuel and diesel tax rates.
- Washington State imposed an additional 1.2 percent business and occupation tax on specific financial institutions.

Increasing statutory revenue sharing would also make the state's overall revenue sharing practice more equitable and cost-effective; Michigan's distribution formula for statutory revenue sharing accounts for the service needs and revenue capacity of local governments, whereas constitutional revenue sharing distributes funds on a per capita basis.

Policy makers typically have several objectives for state aid, including improving the quality of local services, reducing fiscal disparities among local governments, and allowing for reductions in local taxes. Each of these goals can be achieved much more cost-effectively through equalizing aid formulas that account for service needs and fiscal capacity and that don't simply distribute aid on a flat per capita basis. Fully funding statutory revenue sharing would mean a larger share of total revenue sharing is distributed in a way that actively considers the needs of localities.

Create a special state fund to distribute funds to local governments

The majority of states that earmark a percentage of state sales or income taxes for local governments have a special state fund used to distribute funds to localities (Kass, Pagano, and Omeyr 2020). Examples include Ohio's Local Government Fund, Idaho's Revenue-Sharing Account, and Nevada's Local Government Tax Distribution Account. A special state fund in Michigan would help protect against cuts in state revenue sharing by reinforcing that the funds are set aside for local governments under state law and should not be subject to the state budget appropriations process.

Property Tax Limits

Background

Michigan's local governments rely heavily on property taxes to fund their operations, as shown in Tables 2 and 3, but the state has some of the tightest property tax limits in the country, which puts localities in a fiscal bind.

Table 2: Revenue Structure for Local Governments in Michigan

% General Revenue	All Local Gov't	Counties	Cities & Towns	School Districts
Intergovernmental Revenue	**47%**	**49%**	**23%**	**64%**
State Aid	44%	37%	17%	63%
Federal Aid	4%	7%	5%	1%
Local Transfers	0%	5%	1%	0%
Own-Source Revenue	**53%**	**51%**	**77%**	**36%**
Taxes	30%	22%	38%	29%
Property Tax	27%	21%	30%	29%
Sales Tax	0%	0%	0%	0%
Income Tax	1%	0%	5%	0%
Other Taxes	1%	1%	4%	0%
Charges	18%	23%	29%	6%
Miscellaneous	5%	6%	9%	2%

Source: U.S. Census Bureau (2017).
Note: Data for all local governments includes special districts.

Michigan is not unique in this regard; property taxes account for a large share of own-source revenues for local government in nearly every state. Table 3 shows that property taxes accounted for a slightly smaller share of general revenue in Michigan than the national average (27 versus 30 percent), a slightly larger share of own-source revenues (52 versus 47 percent), and a significantly larger share of tax revenues (91 versus 72 percent). While overall reliance on property taxes in Michigan is close to the national average, the property tax is particularly important for local governments' fiscal health in Michigan because they have little access to other types of tax revenue.

Excluding property taxes, local governments in Michigan raised only 2 percent of their general revenues from other taxes, compared to 11 percent for the United States as a whole (see the section on Local Revenue Options for more on this issue). Most notably, Michigan is one of only 13 states without any local sales tax (U.S. Census Bureau 2017). State aid and user charges are both essential components of local governments' revenue mix and have important strengths, but they also have their limits. State aid is often cut during recessions, and charges are generally earmarked to fund specific services, restricting local governments' ability to use them to fund other programs (Yuan et al. 2009). This highlights the need for greater local control of the property tax.

Table 3: Reliance on Property Taxes in Michigan Compared to U.S. (2017)

	All Local Gov't	Counties	Cities & Towns	School Districts
<u>% General Revenue from Property Taxes</u>				
U.S.	30%	29%	28%	37%
Michigan	27%	21%	30%	29%
Michigan state ranking	28	42	17	25
<u>% Own-Source Revenue from Property Taxes</u>				
U.S.	47%	43%	36%	83%
Michigan	52%	41%	39%	80%
Michigan state ranking	14	28	18	26
<u>% Tax Revenue from Property Taxes</u>				
U.S.	72%	71%	55%	96%
Michigan	91%	94%	77%	100%
Michigan state ranking	13	8	14	1 (Tie)

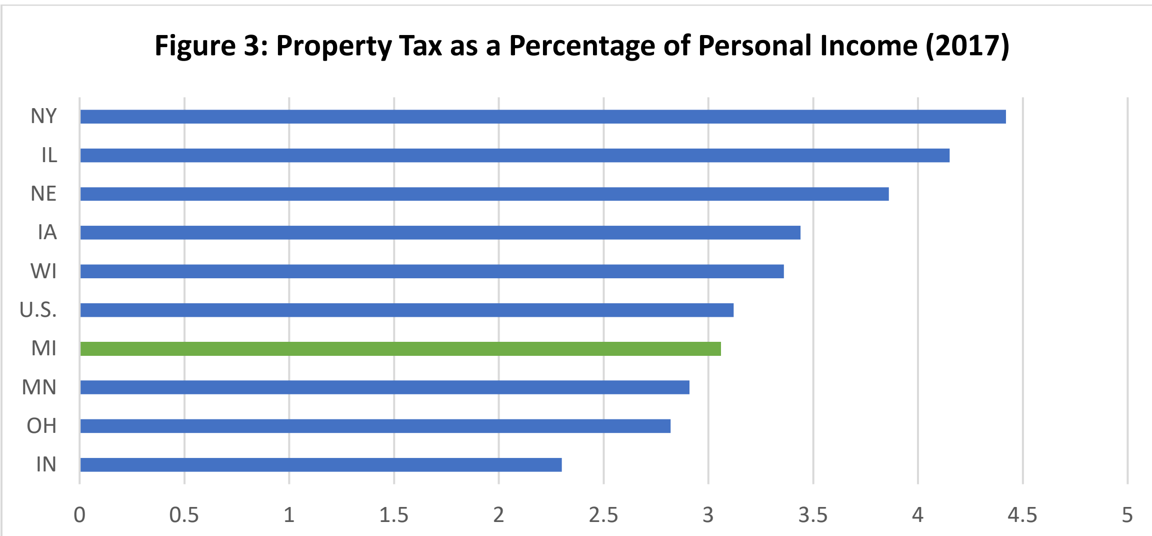
Source: U.S. Census Bureau (2017).
Note: Data for all local governments includes special districts.

Michigan is unique in its restrictiveness of property tax limits. States typically use one of three main types of property tax limits, but Michigan uses all three (Sands and Skidmore 2015; Significant Features of the Property Tax 2020):

- **Rate limit:** Michigan has a complicated set of rate limits (Pratt 2016). The general rate limit is 15 mills, excluding debt service. The city charter rate is limited to 20 mills, but can be exceeded with voter approval. An override process allows for the aggregate rate for local governments to be increased up to 50 mills with a majority vote of the electorate. Property taxes in Michigan and most other places are expressed in mills, which measures the amount of taxes due per $1,000 of assessed value.
- **Assessment limit:** Since Michigan voters passed Proposal A in 1994, annual increases in taxable values are limited to the lesser of either the inflation rate or 5 percent of assessed value. Only when a property is transferred to a new owner is the property reassessed at its market value.
- **Levy limit:** Since Michigan voters passed the Headlee Amendment in 1978, annual increases in a jurisdiction’s property tax revenues have been limited to the inflation rate, with an exclusion for new construction.

The assessment limit and levy limit both restrict annual increases to the rate of inflation, which is lower than most other states’ restrictions. Measuring the restrictiveness of states’ tax and expenditure limits (TELs) more precisely is challenging, though, because the details of the limits vary widely. Three studies have done so, considering all of the important details of these programs and ultimately ranking Michigan either second or sixth in restrictiveness (Amiel, Deller, and Stallmann 2009; Park, Park, and Maher 2018; Wen at al. 2020).

The strict property tax limits in Michigan were a response to residents' and businesses' perception that the property tax was unfair and burdensome (Kleine 1990). While concern about the tax burden may have been an issue for the state in the past, that is not necessarily the case today. Compared to some nearby states and to the United States as a whole, the property tax as a percentage of personal income in Michigan for 2017 was relatively low (see Figure 3).



Source: Lincoln Institute of Land Policy, Significant Features of the Property Tax (2020).

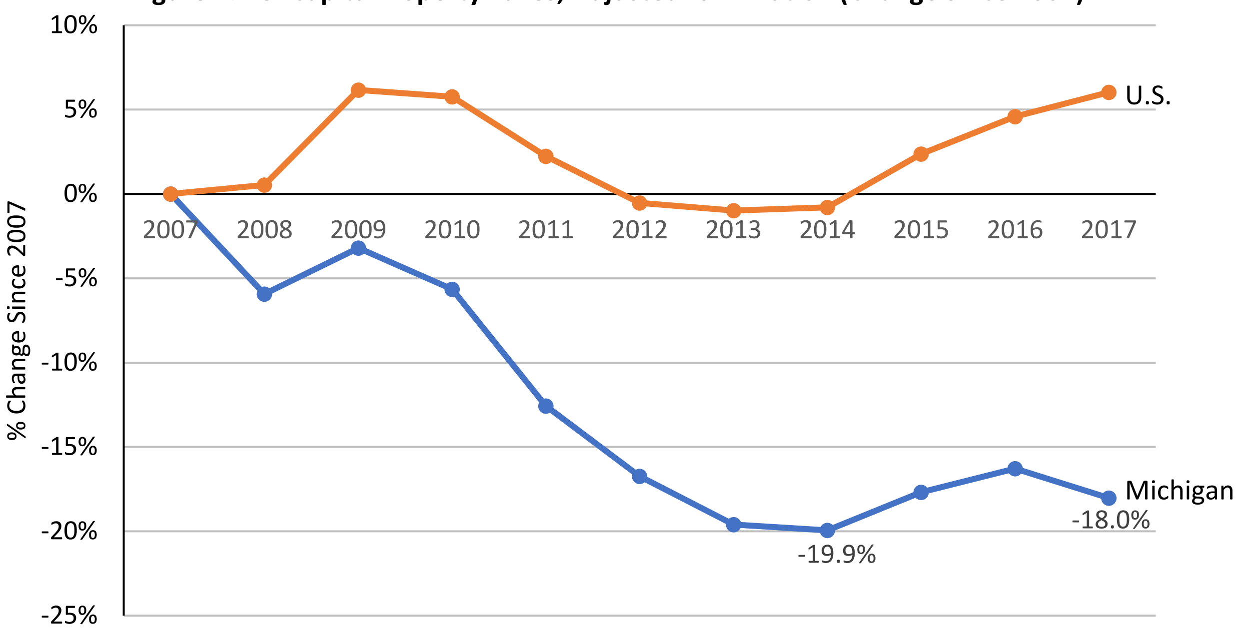
Evidently, Michigan's levy limit is very unusual. Ordinarily, levy limits simply restrict annual increases in a jurisdiction's property tax collections, often with exclusions for new development and debt service. In effect, these levy limits are operationalized by requiring local governments to adjust their mill rates when the property tax base increases rapidly, but state laws rarely explicitly mention rate adjustments. As a result, if the property tax base grows slowly or declines, local governments can raise their mill rates as long as their total collections do not grow faster than allowed under the state's levy limit.

In contrast, Michigan's levy limit requires reductions in mill rates when the property tax base grows rapidly ("Headlee rollbacks") but does not allow increases in mill rates without an override vote when the property tax base grows slowly or declines. Michigan jurisdictions used to have the flexibility to raise their mill rates in these situations, but the ability to use tax rate rollups was eliminated around 1994 in connection with Proposal A school funding reforms. An informal survey of property tax experts in 21 states with the tightest levy limits in the country found that, unlike Michigan, almost no state restricts the ability of local governments to raise mill rates when the property tax base grows slowly or declines.

The inability to raise mill rates led to dramatic declines in property tax revenues during and after the Great Recession, when property values in Michigan declined significantly. Statewide taxable value fell 17.9 percent between 2008 and 2012 (Kleine and Schultz 2017). The decline in property values in Michigan was considerably larger than the national average of decline—most states experienced significant declines in inflation-adjusted property values, but very few had declines as large as Michigan's. Real per capita property taxes declined nearly 20 percent from 2007 to 2014 in Michigan, the fourth-largest decline from peak to trough in the country, and values were still 18 percent below their 2007 peak in 2017. Nationally, real per capita property taxes only fell 6.7 percent from their 2009 peak and had fully recovered by 2017 (see Figure 4).

One of the biggest strengths of the property tax as a revenue source is that it is far more stable than sales and income taxes over the business cycle (Anderson and Shimul 2018). While the property tax base is usually more stable than other tax bases, research shows that the stability of property tax revenues is largely due to the flexibility local policy makers usually have to raise rates to bring in sufficient revenues to fund their operations (Mikesell and Liu 2013). Because Michigan localities do not have the typical flexibility to raise rates, they did not benefit from the stability of the property tax during the Great Recession.

Figure 4: Per Capita Property Taxes, Adjusted for Inflation (Change Since 2007)



Source: U.S. Census Bureau (2017).

Recommendations to Reform Michigan's Property Tax Limits

Given the political challenges of completely removing an existing tax limit, we instead focus on options to reform Michigan's property tax limits. Giving local governments more control over the property tax would enable them to fund general government functions with a more stable revenue source; however, changes would likely require a statewide public referendum, as existing limits were written into the state constitution after the 1978 and 1994 ballot measures (Headlee Amendment and Proposal A).

Allow local governments to raise mill rates when the tax base grows slowly

As mentioned previously, Michigan's levy limit is unusual in that local governments are not able to raise mill rates without an override vote when the tax base grows slowly or declines, and this restriction erodes the stability of the property tax. To change this, Michigan should reauthorize tax rate rollups.

Use a better measure of inflation for the state's levy limit—or simply set a fixed limit

The Headlee Amendment restricts annual growth in property tax levies to the lesser of 5 percent or inflation, excluding new construction and improvements. Since 1982, the inflation rate has been less than 5 percent in all but one year (1990) and has been lower than 3 percent in most years since the early 1990s. As a result, Michigan effectively limits growth in property tax levies to the inflation rate, which is a tighter levy limit than most states, although equal to limits in several other states.

Michigan's measure of inflation (the consumer price index, or CPI) has grown more slowly than other measures including the cost of local governments' provision of public services and personal income. For example, the cost of a typical bundle of goods and services purchased by state and local governments has risen 376 percent since 1980, whereas costs for a typical bundle purchased by consumers has grown 305 percent (U.S. BEA 2019, 2020). Thus, if a local government increased its budget to match growth in the CPI starting in 1980, then the real level of local services provided would have fallen by 19 percent by 2018, as the costs of local government purchases have grown faster than the CPI. Over the same time period, personal income has grown 736 percent nationally (U.S. BLS 2019).

Instead of the consumer price index, Michigan should use a more appropriate measure of inflation. One option is to use the Bureau of Economic Analysis' implicit price deflator for state and local governments, which measures changes in the cost of goods and services purchased by state and local governments. This approach would allow for "cost of living" adjustments that maintain current service levels going forward. New Mexico uses this measure of inflation for their levy limit.

A second option is to tie the levy limit to growth in state personal income. This approach would allow localities to make modest improvements in public services over time as the state's economy grows without increasing residents' tax burden relative to earnings. Indiana uses this measure of inflation for their levy limit, which restricts growth in property tax levies (except school districts) to the lesser of 6 percent or the average annual growth rate of Indiana non-farm personal income in the previous six years.

Case Study: Massachusetts' Proposition 2½ During the Great Recession

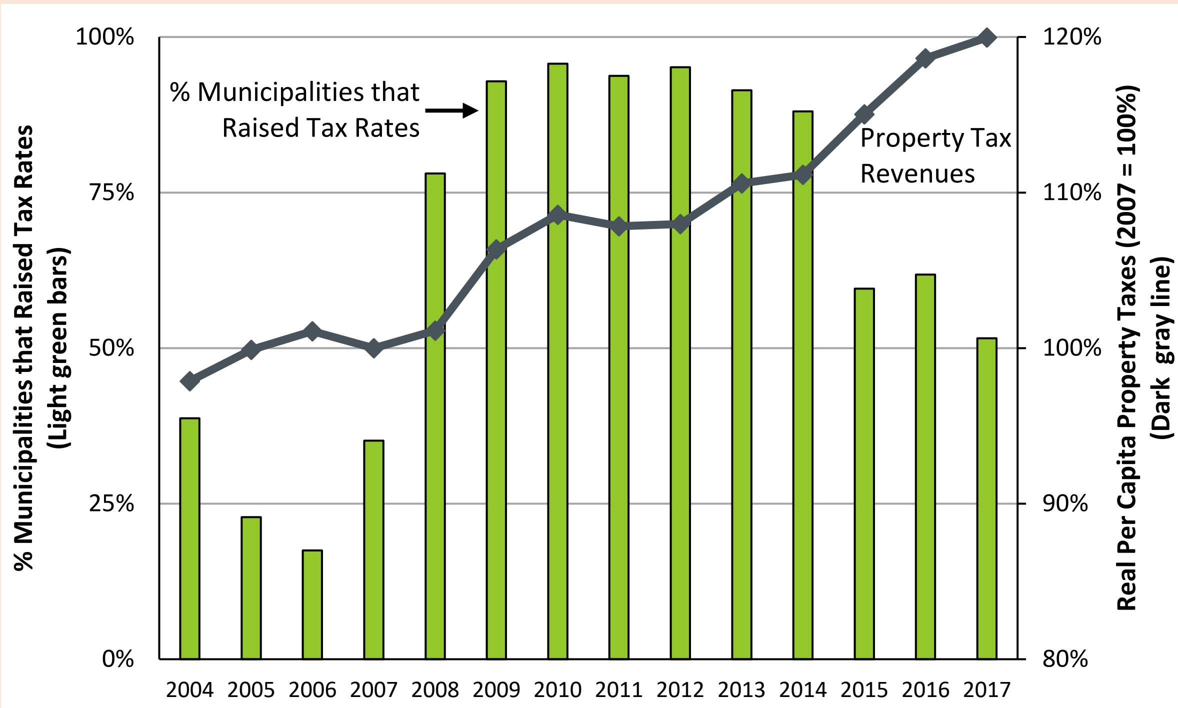
Typically, local governments are free to raise property tax rates as long as total collections do not grow faster than allowed under the limit. The experience in Massachusetts under Proposition 2½—probably the most well-known levy limit and a model for many other states—illustrates how levy limits usually work. Prop 2½ was passed by voters in 1980 and restricts growth in each municipality's total property tax levy to 2.5 percent per year, excluding taxes raised on new construction. In addition, the property tax levy cannot exceed 2.5 percent of total assessed value in a municipality, although municipalities can override the levy limit with a majority vote. As a result of Prop 2½, property taxes fell from 5.2 percent of state personal income in 1980 to 3.3 percent in 1985, a 36 percent decline that meant Massachusetts went from having the second highest property taxes in the nation to the nineteenth highest. In the following decades, Prop 2½ continued to constrain property taxes, with little change in the share of income devoted to property taxes (U.S. Census Bureau 2017).

While there is some evidence that Prop 2½ has eroded the quality of local services (Oliff and Lav 2010), Massachusetts generally avoided draconian cuts while still constraining taxes. Communities remain free to adjust tax rates as long as the total levy does not grow faster than allowed under the 2.5 percent limit. In fact, only around 1 percent of municipalities leave their tax rates unchanged in most years.

The state's experience under the housing boom and bust shows the benefit of this rate-setting flexibility. Figure 5b shows that during the peak of the housing boom in 2005 and 2006, only 20–25 percent of municipalities raised tax rates; with rapidly growing property values, most municipalities were required to cut rates to avoid large increases in property tax bills. However, during the housing bust of 2009–2013, 90–95 percent of municipalities raised tax rates, which allowed them to avoid revenue declines when property values were falling. As a result, real per capita property taxes grew modestly. In 2014, real per capita property taxes in Massachusetts were 11 percent higher than in 2007, compared to a 19 percent decline in Michigan, and a 1 percent decline nationally (see Figure 4). Override votes were unnecessary: the percentage of municipalities that passed overrides fell from 12–15 percent during the 2003–2007 period to 5 percent or less in most years since 2010.

Case Study: Massachusetts' Proposition 2½ During the Great Recession (continued)

Figure 5b: Property Taxes Under Prop 2½ in Massachusetts



Source: Massachusetts Division of Local Services (2020); U.S. Census Bureau (2017).

Local Revenue Options

Background

Michigan's local governments are very limited in how they can raise revenues. While every level of government has the property tax available as a tool, other taxes and fees are largely not allowed (see Figure 6). A burdensome property tax seems to historically be a major concern for Michigan state officials, but allowing for local diversification of revenue sources allows local governments to reduce their reliance on the property tax. Another benefit of having revenue diversification is that it can reduce a local government's reliance on state aid.

Figure 6: Taxes Authorized to Different Levels of Government in Michigan

	Property Taxes	Income Taxes	Retail Sales Taxes	Motor Fuel Taxes	Vehicle License Taxes	Utility Users' Taxes	Alcohol Taxes	Tobacco Taxes	Marijuana Taxes	Casino Gambling Taxes	Restaurant Meals Taxes	Hotel/Motel Taxes	Vehicle Rental Taxes	911 Phone Taxes	Entertainment/admissions Taxes	Soda/Sugar Taxes	Sharing Economy Taxes
State	X	X	X	X	X		X	X	X	X				X			
Counties	X		*						+		#	X	#	X			
Detroit	X	X	*			X			+	X							
Other Cities	X	X	*						+		#	#	#				
Townships, Villages	X		*						+								

* State taxes distributed to localities via revenue sharing
# Select localities can levy
+ State taxes shared with localities

Source: Adapted from Citizens Research Council of Michigan, "Diversifying Local-Source Revenue Options in Detroit" (2018).

Revenue diversification has consistently been proven to be a determinant of local fiscal stability. One group of researchers analyzed the financing of the United States' largest central cities from 1997 to 2008 and found that more diversified revenue structures generate more revenues than revenue structures that rely primarily on the property tax (Chernick, Langley, and Reschovsky 2011). Researchers who analyzed Georgia and Florida counties further found that more diversified revenue structures tend to produce more stable revenue structures (Taeseop Yoon et al. 2013; Yan 2008).

In the past several years, many states have passed legislation enabling municipalities to collect local option taxes. For example, in 2016, both Massachusetts and California legalized marijuana and allowed local governments to levy a local tax on sales (on top of the excise tax each state levies). Another example is Minnesota, which in 2013 expanded the authority for all its counties to impose a fee on registered vehicles; previously, only the metropolitan Twin Cities counties could impose such a fee (Transportation for America 2014). The state also allowed counties to increase the fee from $5 to $10 in 2014 and up to $20 in 2018. The fees are used to fund county highway projects; for instance, Washington County estimates their revenues from this fee at around $4.4 million a year, which in 2020 will be used to fund all or portions of various road paving projects.

Distributing New Revenues to Local Government in Allegheny County, Pennsylvania

Pennsylvania's Allegheny Regional Asset District (RAD) offers one example of increasing revenue diversification. In 1991, the Pittsburgh mayor asked the Allegheny Conference on Community Development to address the issue of funding for area recreational facilities, cultural institutions, and libraries. The conference proposed a legislative effort to stabilize funding for these regional assets, correct funding inequities, reduce reliance on property taxes, and establish a precedent for regional cooperation. In 1993, the Pennsylvania legislature, with bipartisan support, created a special purpose unit of local government (the RAD) with the same geographic boundaries as Allegheny County.

The state authorized Allegheny County to assess an additional 1 percent sales tax and required that half of the revenues from the additional tax be given to the RAD. Today, the RAD distributes those funds to libraries, parks, cultural organizations, regional facilities, and public transit projects. The other half of the 1 percent sales tax gets distributed to the county government and municipalities within the county, which use the funds for general government functions such as road repair. While the state collects the sales tax and redistributes it back to these entities, the law requires the state disburse *all* the funds after retaining costs for program administration, so the state cannot hold back funds to fill its own budget gaps (PA 1953 Act 230).

Recommendations for Local Revenue Options

An additional revenue source at the local level will enable municipalities to better address residents' concerns over the quality of roads, inadequate access to and upkeep of green space, and other services that have suffered due to the lack of funding.

Allow one new local tax or fee at the county level

New local option taxes in Michigan would help some municipalities generate additional revenues; however, the wealthier and higher-capacity jurisdictions would likely be able to collect more of these revenues, because they have stronger tax bases and more staff to implement and collect new taxes and fees. More local option taxes would thus likely exacerbate fiscal disparities among Michigan jurisdictions, because municipalities with low existing revenue-raising capacity often lack the tax bases for new local option taxes in the first place. One researcher used the Representative Tax System (RTS) approach to measure revenue capacity from new local option taxes in Massachusetts municipalities and found that local option tax capacity is concentrated in the Boston suburbs and resort areas in eastern Massachusetts (Zhao 2010). He found that, on average, large cities would benefit more from local sales, meals, and payroll taxes than smaller towns. High-income, property-rich municipalities would gain more local option tax capacity than low-income, property-poor municipalities.

Because of the potential inequities that may result from giving all localities the ability to levy an additional tax, we recommend that *counties* in Michigan be given the authority to levy and collect a new tax or fee (Citizen's Research Council of Michigan 2018b). One of two approaches should follow:

1) Reorganize the local government service delivery model to allow counties to provide more services—or even to allow counties to provide just one more service.

2) Create a system for the county to distribute new revenues to all local units of government within the county, with the county retaining a small portion of the revenues to cover administrative costs and to help pay for other county-provided services.

The benefits of the first option are that it would free up some local funds to help pay for other services or investments, because CVTs are no longer spending money on a specific service or services that the county has taken over. Further, the counties will be able to provide the services at economies of scale with the new revenue they collect. The benefit of the second option is that CVTs and counties will have a new source of revenue that can either be earmarked for a certain type of expenditure need, like infrastructure improvements, or be deposited into general funds and used as local governments see fit.

The state should allow the counties to collect the tax in both of the above approaches; the next best option would be to have the state collect the tax but also require that the state disburse all the money and not be allowed to withhold funds to fill gaps in its own budget.

Allow counties to choose their new tax or fee

Choosing what local option tax counties should be allowed to levy will require a thoughtful approach that evaluates how equitable the new tax should be and determines what exactly the revenue will be used to fund. Ultimately, the type of local tax or fee that should be allowed need not be the same for every county. For example, the regions of Michigan that rely heavily on tourism would benefit from shifting the tax burden to visitors, whereas other regions would need to take a different approach. The state legislature should allow each county to implement one new local tax or fee contingent on each county providing an analysis and rationale for its choice.

Government Fragmentation and Inefficiencies

Background

Local U.S. governments collectively spent about $1.9 trillion in 2017—more than all 50 states combined, excluding state money passed through to local governments. While this might seem surprising at first, there are in fact just over 90,000 units of local government in the United States that provide services such as education, public safety, public health, infrastructure, and more—and their spending adds up quickly. Given the vast sums and sheer number of governments involved, it is reasonable to ask if there is too much fragmentation in local government and if public funds could be more efficiently spent in less fragmented environments.

Michigan has 83 counties, 276 cities, 257 villages, over 1,200 townships, and over one thousand special-purpose districts, each responsible for providing certain services. According to the 2017 Census of Governments, Michigan ranks 12th among the 50 states in terms of its total number of local governments (combining general and special purpose governments).

Several Michigan municipalities have implemented cost-saving measures like cooperative agreements, but these measures can only go so far on an individual basis. Duplication still occurs in some places, as overlying governments provide competing rather than combined services. Inefficiencies are also inevitable, and adjacent localities may miss opportunities for collaboration. Government consolidation—both horizontal and vertical—is often recommended as a solution to government fragmentation; however, research does not necessarily support the assertion that consolidation saves money while *also* maintaining or improving service levels (Kavanagh 2020).

Further, residents may resist consolidation because they fear a loss of community history and identity. A review of the existing literature on the topic leads to the conclusion that, according to Christopher Goodman of Northern Illinois University, "increased horizontal fragmentation, particularly among general purpose local governments, is associated with decreased per capita public spending and public revenues" (2019, 139). This implies that consolidation of horizontally fragmented governments could actually be counterproductive. The research on vertical fragmentation is not as conclusive, but evidence tends to suggest that greater vertical fragmentation leads to greater inefficiency in local government.

Many stakeholders in Michigan believe that increasing local revenues must be accompanied by policies that address inefficiencies in local government. There was at least one attempt at this approach when Governor Richard Snyder implemented the Economic Vitality and Incentive Program (EVIP) in 2011. The program provided incentive payments to localities that engaged in certain types of activities, such as service consolidation; however, the program had too many requirements and not enough incentives to make it worthwhile for many local governments to participate. Michigan can learn from this experience and craft a new approach that encourages local governments to experiment with efficiency-improving measures without bogging the localities down with superfluous compliance requirements.

Recommendations to Reduce Fragmentation and Improve Efficiencies

Because of the potential downfalls of consolidation, we recommend instead two different approaches: networked enterprise and government as a platform. Both are meant to be initiated by the local governments themselves, but the state can take certain actions to make either more appealing for localities to implement.

Local Governments as Networked Enterprises

A “networked enterprise” connects previously separate actors in the pursuit of a shared objective and multiplies their collective power to achieve the objective. Networks are often closely associated with information technology—for example, a social media application like Facebook. But networks also exist beyond the digital world and the distributed and essentially free communication made available by modern information technology has given rise to the increasing prevalence of networked organizations in the physical world.

As local governments begin to use this collective approach, we see how networked organizations can solve challenging community problems without growing public budgets. Networked enterprises attempt to improve the lives of community members by making a big impact on complicated issues like education, health and wellness, mobility, and more. Clearly, a local government would have to vastly expand its taxing and spending in order to make a similar impact through a traditional, bureaucratic model. For example, San Antonio, Texas, tried the networked enterprise model and has seen great progress on indicators such as high school graduation rates, healthcare access, and diabetes rates. The city worked with the community to create a community vision in 2010, and that vision has since survived three mayoral administrations.

Networked enterprises can also improve the perceived value of local government when anchored by a strong community vision that reflects the will of the community. A networked enterprise aligns public, private, and nonprofit resources with that vision. Networked enterprises have several common and well-understood characteristics. State policy makers could support local government capacity in acquiring these characteristics in many different ways:

- Make it easier to obtain exemptions from state mandates on how local communities operate their governments. Networked enterprises can find innovative and effective solutions to local problems, but one-size-fits-all mandates from state governments, however well-intended, can impede these innovations. Flexibility is needed; for example, California’s Department of Education made an explicit offer to school districts to collaborate to eliminate or reduce burdensome regulations.
- Provide support for evidence-based decision making. States can encourage local governments to use evidence-based decision making. For example, a state program that awards funding to local governments on a competitive basis may give preference points to applicants who propose to implement evidence-based programs. A related practice is to create or identify existing clearinghouses of evidence-based interventions; some states create their own, and others direct local governments to existing federal resources. Ohio has a clearinghouse for education and California has one for child welfare, for example.
- Help make data needed for regular feedback on key indicators of community condition available to the public. Michigan could develop data clearinghouses to make it easier for local governments to monitor indicators of progress on tough issues and facilitate data-sharing between local agencies. However, it would be inadvisable for states to require local governments to monitor particular indicators, as the process of selecting and prioritizing indicators to track is an indispensable part of putting together a community vision.
- Provide training on how to run a network. States and quasi-state agencies often provide training programs for local officials, but they typically focus on how to better manage

bureaucracy, not how to manage a more efficient network. In a networked enterprise, however, local government shifts from a “doer” to a “convener,” which requires a different skill set. States could work with organizations that promote practices in support of networked enterprises, such as the National Civic League, Public Agenda, Everyday Democracy, and the National Coalition on Dialogue and Deliberation.

Local Government as a Network in San Bernardino County, CA

In 2009, San Bernardino County had an $80 million deficit. At the same time, the county approved salary and benefit increases for employees. New leadership arrived to turn the situation around, and their solution included more prudent management decisions. However, if too many pressing issues in the communities that San Bernardino County government served went unaddressed along the way, the communities would not be attractive places to live or do business. The county government did not have the capacity to take all of these issues on effectively; they needed to enlist the aid of others via a networked enterprise.

The county conducted a detailed assessment of the issues and found that high poverty rates, high unemployment rates, low graduation rates, and low rates of enrollment in higher education were prevalent—a compelling reason for different organizations from across the San Bernardino area to come together. With facilitation by two key regional agencies, the San Bernardino County Council of Governments and the San Bernardino County Superintendent of Schools, the county formed groups comprised of stakeholders from across the communities to clearly define the nature of a particular challenge and then develop and carry out solutions.

The county had to shift from an organization acting to address community challenges to one that convenes and connects other organizations, which in turn address the community's needs. That convener role put the county in the position of tracking which partners accepted responsibility to take on a given action, holding those partners to their word, and making sure that the groups comprising the networked enterprise continue to provide input and assistance and to create new synergies and ideas to advance shared goals.

The county also convened occasional larger meetings with leaders of all the stakeholder groups to address interdependencies among the challenges. For example, helping low-income youth succeed from cradle to career is not just a matter for public schools; health and housing issues are often important contributing factors. The county's groups for education, housing, and wellness thus worked together on a pilot program to help low-income youth move up and out of their affordable housing communities. The Building Upward Mobility Program provided reading buddies to preschoolers; health screenings, flu shots, and nutrition education to children; and social readiness and safety skills to middle school students. Many indicators have been positively affected by this effort; for example, third-grade literacy has risen to 40 percent from 30 percent in 2015, and child deaths are down 21 percent over 10 years.

The county's networked enterprise has also produced other results. The Jobs and Economy group did a study of "business-friendly best practices" from across the local governments located in the county, and it gathered recommendations from the local business industry on what more the local governments could do. The resulting inventory of best practices provided useful ideas and local exemplars that have implemented those ideas. None of these accomplishments would have been possible if the county government had worked alone.

Source: Shayne Kavanagh, GFOA, "Network Enterprises —An Information Age Solution to Enduring Problems?" (2020)

Government as a Platform

Government as a platform is another Information Age model, but it applies to basic public services rather than big-picture community goals. In the traditional model, government departments are service providers; this model is instead about working with the community to determine the service objectives of government and then "plugging in" the most effective service providers (O'Reilly 2017). Regardless of whether a provider ends up being the local government itself, a private business, a nonprofit, another public organization, or an activity performed directly by the citizens themselves, the local government acts as a coordinator for the best means of accomplishing community objectives.

Two features make government as a platform distinct. This approach aims to look comprehensively across the entire government and find the best service providers, in contrast with the more ad hoc approach typical of most local governments. It also prioritizes providers that can do the job. Government as a platform does not care if a service provider is from the public sector, private sector, or nonprofit sector; it is simply looking for the provider that can best provide the service.

> Getting It Done in Colorado
>
> The City of Englewood, Colorado, has explored its potential to operate as a platform, rather than a traditional bureaucracy. Realizing that the cost to run its fire department was increasing rapidly due to workers' compensation, overtime, and unfunded asset maintenance costs, Englewood decided it needed to address the problem. After reviewing all the potential options, Englewood chose to merge its fire protection services with the City of Denver's. The new shared service saved Englewood about $3 million annually—33 percent of its original budget for the fire department—because it was able to close a fire station that one of Denver's stations was close enough to replace and still maintain acceptable response times.
>
> *Source: Shayne Kavanagh, GFOA, "Government as a Platform: Plugging In the Best Service Providers" (2020)*

Research suggests a three-step process that local governments can use to become a platform:

- Program inventory. Programs like animal control or tree services are directly relevant to how people experience local government—and therefore far more useful in organizing discussions around how to provide services, as opposed to working through departments or line items. A program inventory should include all programs in the government that provide a discrete service leading to an identifiable result or benefit for the public. An inventory clarifies exactly what the government does.
- Opportunity identification. Identifying opportunities may be as simple as convening participants from various local agencies around a table and comparing program inventories. Moffat County, a rural community in Montana, did this and found that over half its budget was comprised of programs that overlapped with its school district, regional hospital, or the internal City of Craig. Cases like these are not all duplicative services but rather proof that there is a large area of opportunity to explore for partnerships, mergers, and outsourcing.

  Research can provide guidance on where to look for opportunities and how opportunities should be evaluated. The Government Finance Officers Association looked at data from

200 cities and counties provided by ResourceX, a firm that helps local governments develop program inventories, to see which programs were most commonly judged by the local governments themselves as having potential for partnership (see Appendix 4 for detailed information on the results). For cities, many of the programs identified as the most shareable are quite small as a percentage of a department's budget. This indicates that cities are more likely to start the platform model with smaller programs. Maintenance programs come up often as well, indicating that cities most readily recognize the opportunity for sharing such basic functions. For counties, the most sharable services are a larger share of a department's budget. A number of maintenance services are identified as sharable, but other services are sharable as well.

Case study research provides guidance on how to choose among several opportunities. The first lesson is that sharing services needs to be motivated by a clear goal; in many cases, this goal will be cost reduction, but there must be an obvious motivation to make this a compelling goal. The second lesson is to ensure economies of scale are truly available by sharing a service, as many benefits will come from spreading certain fixed costs over a larger population of taxpayers. The third lesson is to look for opportunities to share services with organizations that are also highly motivated to share and where the interests of both parties are compatible. The fourth lesson is to be mindful of the role of competition, which is especially important if local government is considering outsourcing to a private firm.[4] If cost savings is a goal of the local government, there are a number of other conditions besides competition that must be present in order for contracting out to a private firm to work. The conditions for contracting out can be found in Appendix 5.

- Implementation. Partnering on fire services might be a big first step for many local governments. Moffat County, Montana, started with an easy opportunity when it discovered that both the hospital and county jail had large laundry operations. The hospital found that its approach to laundry was far less cost-effective than the county's, so it began shipping its laundry to the county, which also brought new revenue to the county.

  Whether the service driving the partnership is big or small, it is important to define the scope of services and the desired cost. The shared service should also have a governance mechanism that allows the participating governments to influence how the service is provided. Englewood, Colorado, has formal definitions of the services that will be provided and the quality of services expected. It also has a special point of contact within the Denver Fire Department with whom the city can address concerns.

  Finally, delivering services through a partnership requires different management skills than delivering a service using people employed directly by the government. For example, partnerships usually require a better definition of the desired goals, timelines, and outcomes for the parties involved than for a service administered by the government itself. This is because the government has less ability to control the day-to-day actions of

[4] The necessary role of competition in public service outsourcing is discussed extensively in: Elliott D. Sclar. *You Don't Always Get What You Pay for: The Economics of Privatization.* Cornell University Press: Ithaca, New York. 2001. See also: John D. Donahue. *The Privatization Decision: Public Ends, Private Means.* (New York, New York: Basic Books). 1989.

its partners than its own employees. Therefore, it can't easily direct partners to change direction. This means that everyone needs to be aligned toward the same goal from the beginning.

Overall, government as a platform has many benefits. It can positively impact economization because developing a program inventory helps a government decide what services it should provide, and the program inventory provides a basis for working with others to provide those services, pooling scarce resources and guarding against wasteful duplication. Government as a platform can also positively impact efficiency because it helps local governments find more cost-effective ways to provide services, access economies of scale, or take advantage of other cost differentials that can be provided by other *service* providers.

Additionally, government as a platform requires governments to create some new capacities, such as developing a program inventory, managing contracts, and defining goals and standards for services. State governments might be able to help local governments develop these capabilities. For example, Iowa requires local governments to file copies of internal local service agreements with the state, creating a central repository of agreements that can be used as models elsewhere. States can also create processes for local governments to more easily seek waivers for state requirements that would otherwise prevent service sharing.

Conclusion

Michigan's local governments were headed for fiscal distress before COVID-19, and the pandemic has only sped up the inevitable. Over the past few decades, the state government has implemented so many barriers for localities to achieve fiscal stability that Michigan's counties, cities, townships, and villages could not adequately prepare for or recover from a crisis.

State leaders can take concerted efforts to improve the fiscal health of local governments in Michigan. The fiscal health of localities impacts local residents and businesses—all residents of Michigan, on whom the state cannot turn its back.

This report details several recommendations for Michigan to implement and bolster the fiscal health of its local governments. Improving state aid would likely be the quickest recommendation to implement, would put more dollars to work for the residents of Michigan, and would likely have the most visible impact. Relieving some of the property tax limitations or authorizing an additional local revenue source would, over time, also improve the capacity and stability of local government budgets. Efforts to address inefficiencies at the local level will likely take a lot of time, but such efforts have the potential to produce cost savings and improve how residents and businesses view their local governments over the longer term.

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Appendix 1: Unrestricted State Aid to Localities

	% Change in Real per Capita Unrestricted State Aid			Unrestricted State Aid per Capita (in Real Dollars)			Unrestricted State Aid as % General Revenue (2017)
	2007-17	2007-12	2012-17	2007	2012	2017	
United States	***-22%***	***-19%***	***-4%***	***$61.38***	***$49.87***	***$47.97***	***3%***
Arizona	-23%	-34%	16%	$252.90	$168.14	$195.82	15%
Florida	-17%	-26%	12%	$65.66	$48.43	$54.26	6%
Idaho	-10%	-3%	-7%	$55.55	$53.83	$50.09	6%
Illinois	-4%	-12%	9%	$297.62	$261.52	$285.27	18%
Massachusetts	-30%	-35%	8%	$171.34	$110.61	$119.63	5%
Michigan	**-34%**	**-33%**	**-2%**	**$105.91**	**$71.23**	**$69.68**	**8%**
Minnesota	-23%	-28%	6%	$127.94	$92.75	$98.33	7%
Mississippi	-10%	-11%	1%	$178.48	$158.87	$159.76	17%
Montana	-2%	-4%	2%	$80.36	$77.01	$78.51	10%
Nevada	-26%	-35%	14%	$276.60	$180.92	$205.70	27%
New Jersey	-41%	-28%	-18%	$149.74	$108.08	$88.84	7%
New Mexico	-36%	-32%	-6%	$277.43	$189.08	$178.24	15%
North Carolina	34%	20%	11%	$39.02	$46.98	$52.16	7%
North Dakota	107%	44%	44%	$52.15	$75.19	$107.99	7%
Tennessee	1%	-10%	12%	$61.90	$55.89	$62.54	5%
Wisconsin	-35%	-3%	-33%	$193.73	$188.48	$125.37	12%
Wyoming	-40%	-25%	-20%	$464.20	$347.12	$277.81	24%

Source: Census of Government Finance 2007, 2012, 2017; Kass, Amanda, Michael Pagano, and Farhad Kaab Omeyr. "How States Provide Cities with General Revenue: An Analysis of Unrestricted State Aid" (2020).

Appendix 2: State Sales Tax Revenue Sharing

As of 2019, 45 states had some form of a state-level general sales tax. Of those 45 states, less than a third (13) allocate a portion of state sales tax collections to municipalities for unrestricted use. The majority of states that share sales tax revenue with municipal governments also permit local sales taxes.

State	% of State Sales Tax Collections Shared with Local Governments (FY 2019)*	Special State Fund for Distributing Funds to Local Governments	Local Tax Permitted?
AZ	22%		Y
CT	7%	Municipal Revenue Sharing Account (starting FY2018)	N
FL	8%*	Half-Cent Sales Tax Clearing Trust Fund; Municipal Revenue Sharing Trust Fund	Y
ID	12%*	Revenue-Sharing Account	Y
IL	37%*	Local Government Tax Fund	Y
ME	2% of receipts to state General Fund	Local Government Fund and Disproportionate Tax Burden Fund	N
MI	10% (estimate)		N
MS	14%		Y
NV	N/A	Local Government Tax Distribution Account	Y
NM	7%		Y
ND	9%*	State Aid Distribution Fund	Y
TN	4%		Y
WY	31%*		Y

Source: Kass, Amanda, Michael Pagano, and Farhad Kaab Omeyr. "How States Provide Cities with General Revenue: An Analysis of Unrestricted State Aid" (2020).

Note: This table only captures revenue sharing as it relates to municipal governments, and it is important to note that in addition to this information, state sales tax revenue may be allocated to other local governments and/or specific budget areas.

Appendix 3: Select State Tax Rates and Collections

State Recreational Marijuana Excise Tax Rates as of January 1, 2020	
State	**Tax Rate**
Alaska	$50/oz. mature flowers, $25/oz. immature flowers, $15/oz. trim, $1 per clone
California	15% excise tax (levied on wholesale at average market rate)
	$9.65/oz. flowers & $2.87/oz. leaves cultivation tax, $1.35/oz. fresh cannabis plant
Colorado	15% excise tax (levied on wholesale at average market rate)
	15% excise tax (retail price)
Illinois	7% excise tax of value at wholesale level, 10% tax on cannabis flower or products with less than 35% THC, 20% tax on products infused with cannabis, such as edible products, 25% tax on any product with a THC concentration higher than 35%
Maine	10% excise tax (retail price), $335/lb. flower, $94/lb. trim, $1.50 per immature plant or seedling, $0.3 per seed
Massachusetts	10.75% excise tax (retail price)
Michigan	10% excise tax (retail price)
Nevada	15% excise tax (fair market value at wholesale), 10% excise tax (retail price)
Oregon	17% excise tax (retail price)
Washington	37% excise tax (retail price)

Source: Tax Foundation, "Facts and Figures 2020: How Does Your State Compare?" (2020).

State & Local Excise and Selective Sales Collections per Capita Fiscal Year 2017						
State	Collections per Capita	Rank		State	Collections per Capita	Rank
U.S.	$570			Montana	$560	21
Alabama	$614	17		Nebraska	$345	48
Alaska	$516	31		Nevada	$1,028	2
Arizona	$323	50		New Hampshire	$713	10
Arkansas	$512	32		New Jersey	$447	39
California	$481	35		New Mexico	$438	40
Colorado	$462	38		New York	$701	11
Connecticut	$675	13		North Carolina	$437	41
Delaware	$599	18		North Dakota	$664	15
Florida	$565	20		Ohio	$554	23
Georgia	$423	43		Oklahoma	$369	46
Hawaii	$932	3		Oregon	$525	28
Idaho	$373	45		Pennsylvania	$752	9
Illinois	$816	7		Rhode Island	$687	12
Indiana	$520	30		South Carolina	$332	49
Iowa	$530	26		South Dakota	$554	22
Kansas	$469	37		Tennessee	$506	33
Kentucky	$646	16		Texas	$587	19
Louisiana	$673	14		Utah	$524	29
Maine	$547	24		Vermont	$1,108	1
Maryland	$928	4		Virginia	$532	25
Massachusetts	$437	42		Washington	$835	6
Michigan	$475	36		West Virginia	$782	8
Minnesota	$887	5		Wisconsin	$495	34
Mississippi	$527	27		Wyoming	$351	47
Missouri	$396	44		D.C.	$641	(17)

Source: Tax Foundation, "Facts and Figures 2020: How Does Your State Compare?" (2020).
Note: Excise taxes are sales and other special taxes imposed on select items, such as tobacco products, alcoholic beverages, and motor fuels. This table also includes excise taxes, or selective sales taxes, on amusements, insurance premiums, parimutuels, and public utilities. DC's rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

Appendix 4: Data on Government as a Platform

Data on 200 cities and counties from ResourceX was collected and analyzed by the Government Finance Officers Association (GFOA). The cities ranged in size from 4,768 to 849,576 in population, with an average population of 94,034. The county populations ranged in size from 9,031 to 619,968, with an average of 125,827. GFOA looked to see which programs were most commonly judged, by the local governments themselves, as having potential for partnership.

The first column shows the percent of the department's budget taken up by each program. The next column shows the percent of the entire city's budget, and the last column shows the percent of cities who judged the program to have potential for sharing. The programs within each department are ordered by how sharable the programs were perceived to be.

Program Budgets and the Potential for Sharing

City Governments

Program	% of Department Budget	% of Citywide Budget	% of Cities that identified the program as sharable
Police			
Animal Control	0.4%	0.2%	72%
Police vehicle cleaning, repair, maintenance	2%	1.1%	48%
911, Dispatch	2.3%	1.3%	42%
Public Works			
Fleet Vehicle and Equipment Replacement	3.6%	1.9%	74%
Custodial	0.6%	0.3%	62%
Facility maintenance	5.4%	2.7%	52%
Utilities			
Utility Billing	0.5%	0.1%	34%
Line inspection, repair, replacement	4.8%	1.3%	17%
Parks and Recreation			
Athletic field maintenance	3.2%	0.5%	72%
Grounds management	8.4%	1.3%	63%
Playground equipment repair and maintenance	0.5%	0.1%	44%

County Governments

Program	% of Department Budget	% of County Budget	% of Counties that identified the program as sharable
Health and Human Services			
Family services	9.7%	1.9%	32%
Childcare	1.4%	0.3%	18%
Senior, adult day care (include nursing homes)	7.8%	1.5%	10%
Fire and EMS			
Vehicle and Equipment Maintenance	1.8%	0.3%	69%
Calls for service (non-emergency)	7.9%	1.5%	17%
Engineering			
Data management (GIS)	2.6%	0.2%	56%
Inspection, code enforcement	12.1%	1%	28%
Plan Review	20.2%	1.7%	19%
Sheriff			
Dispatch	4.9%	3.5%	64%
Vehicle maintenance	1.2%	0.9%	41%
Patrol, calls for service	11.8%	8.4%	33%
Public Works			
Roadway operations and maintenance	43.3%	10.5%	84%
Vehicle and equipment replacement	22.2%	5.4%	71%
Building, custodial services	1.8%	0.4%	45%

Appendix 5: Conditions for Outsourcing for Cost Savings

Studies have shown that outsourcing for cost reduction is generally only successful when certain criteria are met (Donahue 1989). Below are crucial tests a given service should meet before it is outsourced to save costs.[5]

Are competitive forces available? Public officials must be capable of sustaining competition, and the government must have the wherewithal to take necessary action to sustain competitive forces, including switching providers when necessary.

Can the results be measured? Outsourcing is more successful when the government has a clear vision for desired results that can be unambiguously measured, which gives the contractor clear performance specifications and allows the agency to more readily modulate service levels to available resources. Further, clear performance specifications allow for more effective monitoring of the service and provide a basis for replacement of an unsuccessful contractor.

Does the agency want just results? The process by which a service is provided is often important in the public sector. For example, law enforcement processes must safeguard civil rights and follow proper safety protocols. In cases where the government requires close control over the means by which a service is performed, outsourcing for cost reductions will generally be less successful, because process constraints limit the ability of private sector firms to use their inherent advantages (e.g., personnel flexibility, creative incentive structures) to deliver cost savings.

Can the agency contract successfully? Fundamentally, using outsourcing for cost savings is a matter of trading lower production costs (e.g., private firm) for higher coordination costs (e.g., contract management). Thus, successful outsourcing requires the government to minimize coordination costs by creating a contract that provides mechanisms for effective monitoring, such as vendor self-reporting of verifiable results, a single point of contact for vendor relations, or staff able to administer the contract.

Do the economics make sense? Outsourcers can deliver cost savings based on economies of scale in service provision (i.e., spreading fixed costs over multiple customers), lower employee costs, and through employing more efficient work processes, owing to their expertise in the service provided. Hence, for service areas in which the agency does not have critical mass sufficient for economies of scale, has high labor costs, or has not optimized work processes, outsourcing can deliver the greatest potential savings. Also, the agency must compare the proposed cost from the private firm to "avoidable costs" the agency can eliminate by outsourcing. For example, if the public employees who used to provide the service will be moved to new roles within the local government, rather than terminated, then the outsourcing will probably not make financial sense.

[5] Outsourcing can have other goals besides cost reduction, in which case the list of test criteria would need to be expanded to fully address these other goals.

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