

# *Expanded School Sinking Fund Taxes*

## **Infrastructure Investment, or Backtracking on Proposal A?**

Prepared by:

Patrick L. Anderson  
Scott D. Watkins  
Ilhan K. Geckil

**Prepared for the Michigan Chamber Foundation**

**Anderson Economic Group**

615 West Ionia  
Lansing, Michigan 48933  
Tel: (517) 374-2596  
Fax: (517) 487-9097

<http://www.AndersonEconomicGroup.com>

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## Executive Summary

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### PROPOSAL A AND SCHOOL FINANCE

On March 15, 1994, Michigan voters approved “Proposal A,” amending the Michigan Constitution to permanently reduce school property taxes, permanently increase the sales tax, and establish a per-pupil funding guarantee for public schools across the state. The tax limitation portion of the amendment requires a 3/4 supermajority vote in both chambers to pass laws that increase limits on the maximum amount of property taxes that may be levied for school district operating purposes.<sup>1</sup>

The statutory tax limits protected by the new provision of the Constitution were listed in a memorandum authored by deputy directors of the Budget and Treasury departments before the election, and distributed by the Governor shortly afterwards.<sup>2</sup> The memorandum lists specifically the sections of the school code that govern the allowable school operating taxes, including those that govern debt, sinking fund, and building & site taxes.

Very soon after Proposal A passed, there were attempts to increase the limits on operating taxes through an expansion of the use of these millages. Governor John Engler rebutted these attempts, stating in a veto message “we cannot stand by and let that historic step forward be reversed piecemeal by those that preferred the old school finance system--a system that was unfair to students and taxpayers alike.”<sup>3</sup> However, before the end of the year 1994, the legislature did enact, and the governor signed, three laws that expanded the allowable school operating and debt millage.<sup>4</sup>

### EFFECTS OF PROPOSAL A AND EXPANDED MILLAGE PURPOSES

Since Proposal A was implemented, funding for school districts has grown substantially. As shown by Figure 1, “Changes in Price, Enrollment, and Taxpayer Funding Since “Proposal A”,” on page 5, and Figure 5, “School Operating Revenue vs. Enrollment,” on page 7, these increases have occurred in an environment of low inflation and steady enrollment, so that real, per-pupil revenue for public schools has increased substantially since Proposal A was passed.

In keeping with the promise of Proposal A, local school district operating property taxes have fallen, with schools receiving increased revenue from the higher state

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1. The ballot description language is included in “Appendix One: Proposal A Ballot Language” on page 24.
  2. The March, 1994 memorandum to Governor John Engler was authored by Patrick L. Anderson, then deputy budget director; and Nick Khouri, then chief deputy treasurer. It is included in “Appendix Two: 1994 Memo on Statutory Tax Limits” on page 25.
  3. The Governor’s 1994 veto message, addressing SB 597 (1994), is included in “Appendix Three: 1994 Veto Message” on page 31.
  4. PA 173 of 1994 allowed for certain districts to levy millage for swimming pools, and exclude that millage from their “operating millage;” PA 278 of 1994 amended section 1351a of the school code to expand the use of school debt millage; PA 258 of 1994 increased the allowable Intermediate School District millage. See Patrick L. Anderson, *The Tax Limits in Proposal A*, Michigan Chamber Foundation, January 1997.

sales tax, the new state property tax, and other sources.<sup>5</sup> Figure 2, “Local School Operating Taxes,” on page 6, shows how local school operating taxes fell sharply in 1994, and the average millage rate for operating purposes has remained steady since then.

However, a growing segment of property taxes—indeed the fastest growing segment of property taxes—has been the various additional taxes levied by school districts such as debt, building & site, and sinking fund taxes. Since 1994—when Proposal A was passed, and a subsequent statutory expansion in the allowable purposes for debt millage was enacted—the revenues from these taxes have exploded. Figure 3, “Debt, Sinking Fund, and Building & Site Taxes,” on page 6, shows how the average millage rate among Michigan Schools for these purposes has grown over 60% in just six years—from an average of 2.6 mills in 1994 to 4.1 mills in 2000. The tax revenue from such millages has grown 117%, to nearly a billion dollars in 2000.

## RECENT LEGISLATIVE INITIATIVES

Michigan legislators are once again exploring ways to increase the taxing powers of local school districts beyond those allowed when Proposal A passed. Several bills have been introduced to allow school districts to levy taxes that will effectively increase operating revenues. House Bill 4824 has had the most success, passing the House in December, 2001. A similar bill, SB 688, was introduced in the Senate in October, 2001.

Both SB 688 and HB 4824 would allow districts to use “sinking fund” taxes to pay costs that go well beyond the proper use of a sinking fund, which is to repay the principal owed on a debt. Passage of such a law would effectively allow schools to increase their operating tax revenue, by using “sinking fund” revenue to cover repair, maintenance, refurbishing, “technology,” and furnishing costs that would normally be paid out of operating funds.

Such a change in purpose is acknowledged in the bill by a provision allowing the tax to be described to voters using words other than “sinking fund,” such as “infrastructure investment fund.”<sup>6</sup> By authorizing 5 additional mills to be levied for such purposes, the legislature would effectively increase the maximum school property tax for operating purposes by 5 mills. For businesses and other taxpayers paying 18 mills in local taxes plus 6 mills in state taxes now, a 5-mill increase would represent more than a 20% tax increase.<sup>7</sup>

5. See “The Taxes Funding Michigan Schools” on page 8.

6. A particularly reckless provision would allow for *unspecified* descriptions of the tax to appear on the ballot. Such a provision would be a green light to experimenting with the language until the voters approve a ballot measure, thus fraying the connection between the actual uses of the funds and the description approved by the voters.

7. For homeowners exempt from the 18-mill operating tax levy, an additional five mills would nearly double their current six-mill state school property tax.

In addition to these bills, there has been discussion of expanding the use of debt millage, building & site millage, and proposing a special state bond issue that would subsidize local expenditures.<sup>8</sup>

## ASSESSING POTENTIAL FISCAL IMPACT

To better understand the impact of such legislation on taxpayers, we simulated the effects of increased school sinking fund tax authority over the next decade, under 3 scenarios.

Each scenario measures the potential impact of HB 4824 over the period 2003-2013, with 10% of the total tax increase occurring in each year. Our base scenario (Scenario One) assumes an average statewide increase of 2.5 mills on both real and personal property taking place over the ten years following passage of the bill. This is equivalent to half of the school districts levying the 5-mill tax by the end of the ten-year period.

This base scenario closely reflects the trend that occurred from the time at which the allowable debt millage purchase was liberalized, 1994, through the most recent year for which data is available, 2000. Over these 6 years the statewide average millage for debt, sinking fund, and building & site taxes increased .25 mills a year. Our base scenario of a 2.5 mill increase over 10 years assumes that, if the legislature liberalizes “sinking fund” millage as it did previously for debt millage, “sinking fund” taxes will grow at about the same rate over the following ten years as the debt millage category grew in the six years following the 1994 law changes.

Scenario Two is more conservative, assuming only a 1.5 mill average statewide increase; Scenario Three assumes a 3.5 mill increase. In each of these alternate scenarios, we also assume that the average millage increases 1/10 of the total change each year for ten years.

Table 1, “Summary of Sinking Fund Tax Impacts,” below, shows the cumulative additional property taxes that would be levied by schools under each scenario over a ten-year period.

**TABLE 1. Summary of Sinking Fund Tax Impacts**

<b>Scenario</b>	<b>Cumulative Property Tax Increase (billions)</b>	<b>Residential Burden</b>	<b>Non-Residential Burden</b>
Base Scenario, 2.5 mill average increase	\$5.43	\$3.37	\$2.06
Scenario Two, 1.5 mill average increase	\$3.26	\$2.02	\$1.24
Scenario Three, 3.5 mill average increase	\$7.60	\$4.71	\$2.89

Source: Anderson Economic Group

8. See “Recent Legislation” on page 12.

These projections are illustrated in Figure 4, “Property Tax Increases Under Different Scenarios,” on page 7. As indicated in the table and figure, our base scenario results in a cumulative tax increase of over \$5.4 billion. The low and high scenarios are for tax increases of \$3.3 billion and \$7.6 billion, respectively. About 5/8 of these tax increases would fall on residential property, and the remainder on non-residential property.

#### **BACKTRACKING ON THE TAX LIMITATIONS OF “PROPOSAL A”**

While the size of the fiscal impact may be surprising, the policy implications should not be. An overwhelming number of Michigan citizens adopted Proposal A, indicating their express agreement with a system that permanently limited school property taxes, and established a funding system that included a permanently higher sales tax rate. They have supported other taxes that have allowed school funding to grow significantly faster than inflation. To now adopt legislation that expands school property taxes—even if disguised somewhat in terminology—would strike many voters as renegeing on that tax limitation commitment.

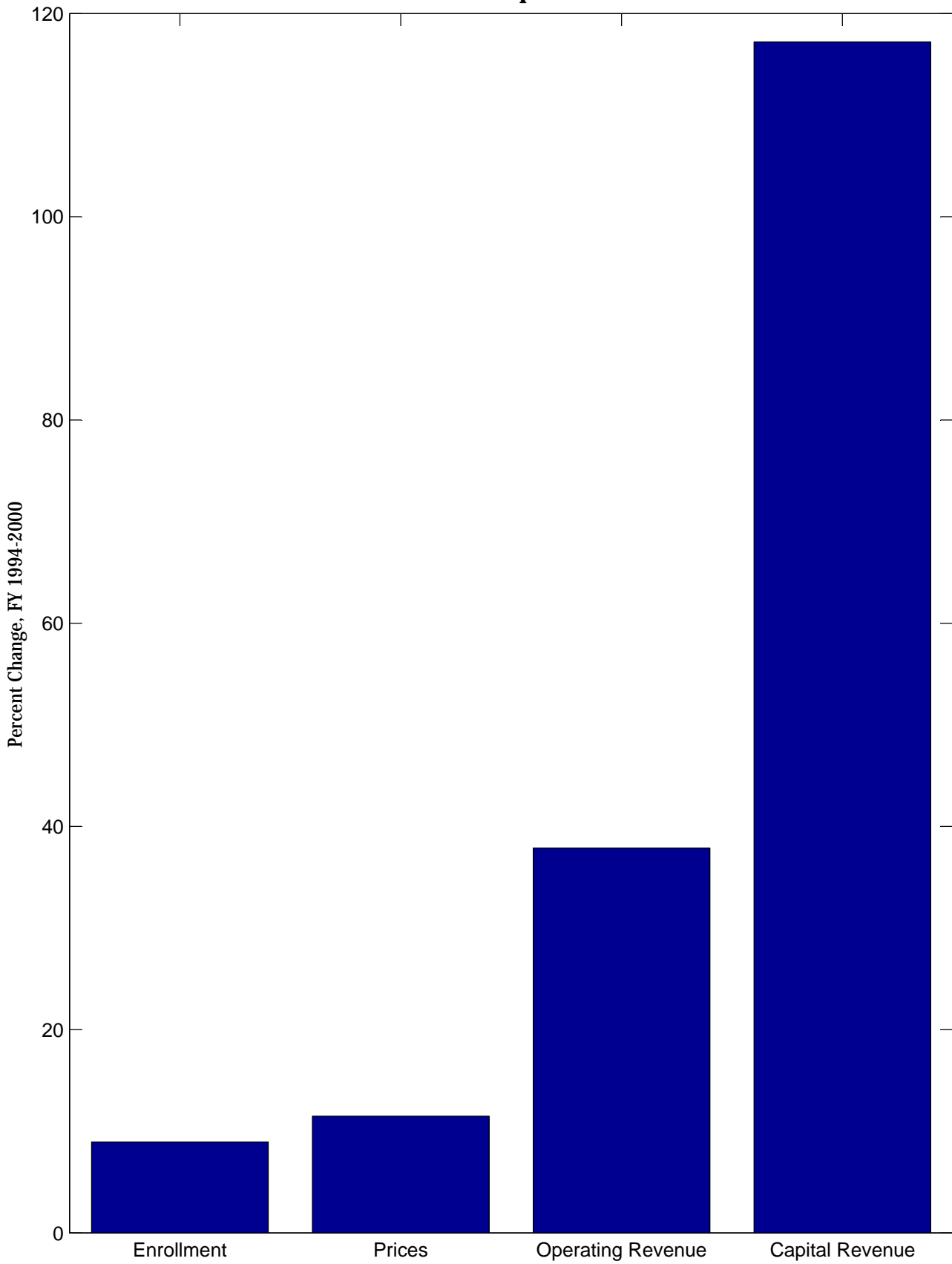
Given that there is no discussion of permanently reducing the sales tax or state property tax rates, many voters would be understandably angry with backtracking on the tax limits in Proposal A.

#### **POLICY OPTIONS**

In addition to the proposed tax increases, Michigan policymakers have a number of options. They include:

1. Retain the current law, noting that Proposal A was overwhelmingly approved, and has largely succeeded in its principal objectives of reducing school property taxes, increasing school funding, and reducing the disparity in per-pupil funding among school districts.
2. Prevent “double dipping” by allowing only one form of capital millage—either debt, sinking fund, *or* building & site—to be levied at any one time.
3. Encourage—or require—that sufficient operating funds be devoted to the maintenance of existing structures, so that local school districts would not find themselves in “crises” arising from unmaintained buildings.
4. Rely more on public school academies—also known as charter schools—that fund their capital expenditures out of the per-pupil operating funds. Charter schools could be especially helpful in areas with growing or declining enrollment. On the other hand, expanding the use of debt, building & site, and sinking fund millage as a source of operating funds would further aggravate the existing disparity in funding between public school academies and traditional public schools.
5. Use the regional taxing authority under current law, which provides for school districts to join together in asking voters to increase local taxes to augment spending for operating purposes. The law allows for up to 3 mills of taxing authority, on an intermediate school district-wide basis.
6. Tighten the statutes governing the allowable purposes for debt millage revenue, to once again prohibit the use of long-term borrowing to pay for short-term assets or operating expenditures. This would not only improve fiscal prudence, it would also increase the confidence with which voters view school bond issues.

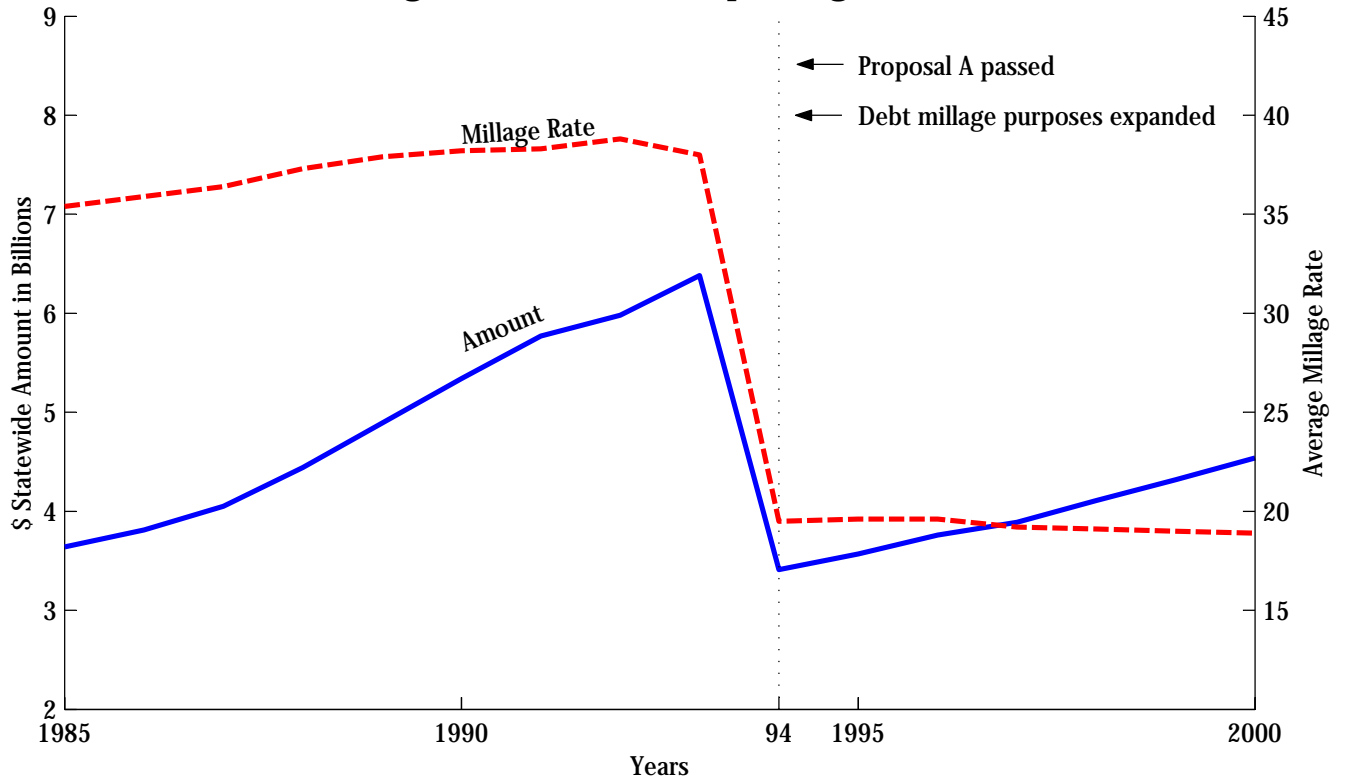
**Figure 1. Change in Prices, Enrollment, and Taxpayer Funding since 'Proposal A'**



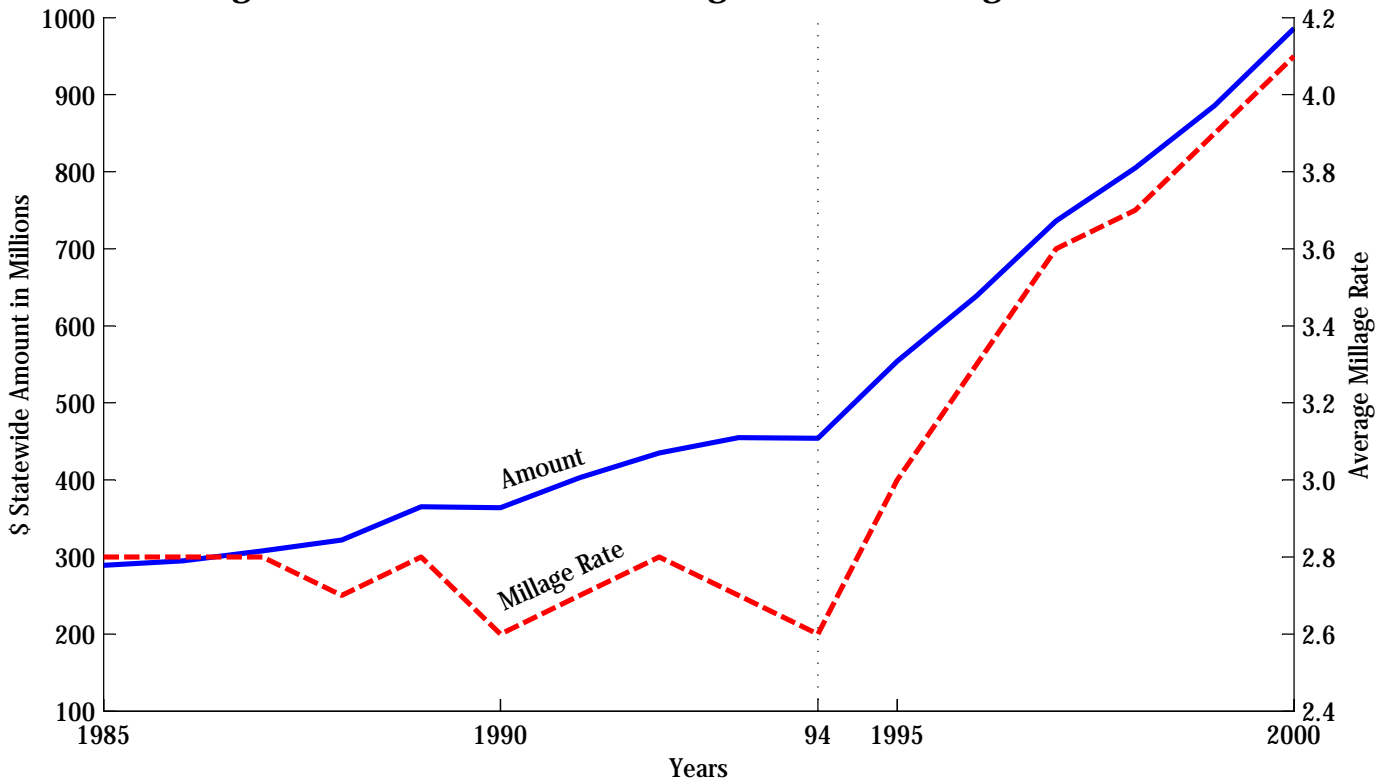
*Source: Anderson Economic Group*

*Data: Michigan Dept. of Education; Michigan State Tax Commission; BEA*

**Figure 2. Local School Operating Taxes**

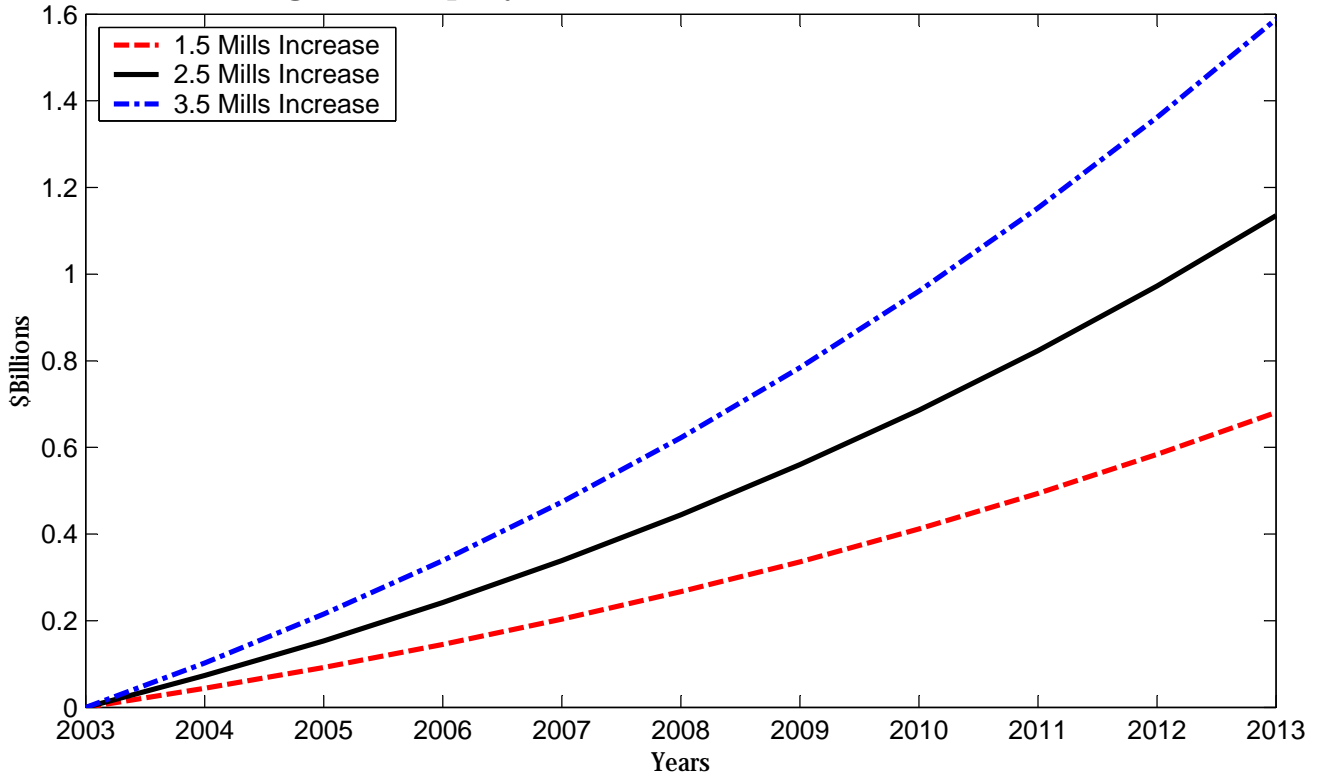


**Figure 3. Local School Debt, Sinking Fund and Building & Site Taxes**

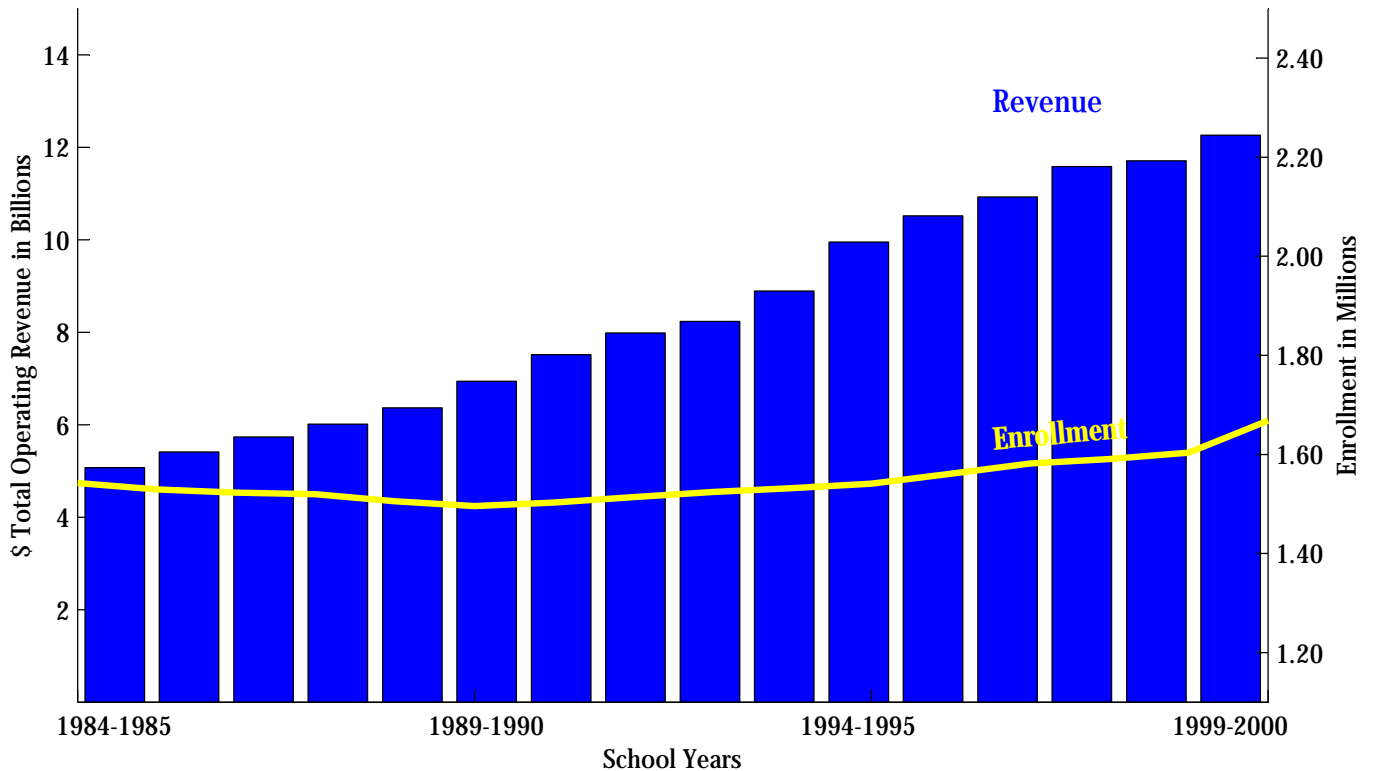


Source: Anderson Economic Group  
 Data: Michigan State Tax Commission  
 Generated Date: 04/10/2002

**Figure 4. Property Tax Increases Under Different Scenarios**



**Figure 5. Statewide Local School Operating Revenue vs. Enrollment**



Source: Anderson Economic Group

Data: Mich. Dept. of Education; Mich. Senate Fiscal Agency; Mich. Dept. of Treasury

Generated Date: 04/12/2002

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## *The Taxes Funding Michigan Schools*

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Public schools are currently financed by a set of taxes, including:

1. Local property taxes of approximately \$4 billion, the majority of which is generated by an operating tax of about 18 mills levied by local school districts on non-home-stead properties. Other local school taxes include hold-harmless taxes, building & site millages, sinking fund millages, and debt millages.
2. A state education property tax of 6 mills on all property, which generates approximately \$1.4 billion.
3. The entire proceeds of the additional 2% sales tax added by Proposal A in 1994, plus a portion of the proceeds of the first 4% sales tax. Of the total sales tax revenue of approximately \$6.5 billion, about three-quarters goes directly to the school aid fund.
4. Portions of the proceeds of other taxes, including the individual income tax, the tobacco tax, liquor excise tax, the real estate transfer tax, and the use tax.<sup>9</sup>
5. Additional taxes that support the K-12 system, including Intermediate School District operating millage, ISD debt millage, and Community College millage.

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## *The Tax Limits Under Proposal A*

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Proposal A, adopted by the voters on March 15, 1994, amended Article IX section 3 to include the following sentence:

A law that increases the statutory limits in effect as of February 1, 1994 on the maximum amount of ad valorem property taxes that may be levied for school district operating purposes requires the approval of 3/4 of the members elected to and serving in the Senate and in the House of Representatives.

The ballot language for Proposal A is included as “Appendix One: Proposal A Ballot Language” on page 24

### **WHAT TAX LIMITS ARE PROTECTED?**

The statutory limits that were protected by Proposal A were listed in a March 2, 1994 memo to Governor Engler by Patrick Anderson (then Deputy Budget Director) and Nick Khouri (then Chief Deputy Treasurer). The text of this memo is included as “Appendix Two: 1994 Memo on Statutory Tax Limits” on page 25. The memo was distributed before the election was held on March 15, 1994.

Listed explicitly in the memo are the various sections of the revised school code that govern operating and capital millage, including the debt, “sinking fund,” and building & site millage authorizations.<sup>10</sup>

Following the affirmative vote of the electorate, the Governor sent the memorandum to the Secretary of the Senate, Clerk of the House, Speaker of the House, Sen-

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9. For a useful summary, see *Annual Report of the State Treasurer*, various years, available from the Michigan Department of Treasury web site.

ate Majority Leader, and other officials, including the state board of education. In his transmittal letter, he stated “We are all obligated to uphold the wishes of the citizens, as expressed by their adoption of this constitutional amendment....The attached memorandum, summarizes these statutory limits.”

## THE 1994 VETO

The Governor did not need to wait long before the legislature tested both the 3/4 vote requirement, and the limits on millage levied for operating purposes. Senate Bill 597 was passed by the legislature in April, and allowed for an expansion of the use of building & site millage, the use of sinking funds for technology purposes, as well as an increase in the allowable purposes for bond funds. The bill was passed without a 3/4 vote.

The Governor returned the bill on April 14, 1994 without signature. In his veto message, he noted that his previous letter had transmitted a memorandum listing the protected tax limits under Proposal A, and that the sections of the school code that the bill would change were on that list. He also found the expanded uses of bond, sinking fund, and building & site millages were “fiscally imprudent” and not an “appropriate” use of these funds. Furthermore, wrote Engler:

Proposal A promised Michigan homeowners permanent property tax relief--guaranteed in the Constitution. That promise cannot and will not be broken...

We cannot stand by and let that historic step forward be reversed piecemeal by those that preferred the old school finance system--a system that was unfair to students and taxpayers alike.

The complete text of Engler’s veto message is contained in “Appendix Three: 1994 Veto Message” on page 31

## SUBSEQUENT CHANGES

The Michigan Chamber Foundation commissioned a review of the tax limits protected by Proposal A in late 1996. In *The Property Tax Limits in Proposal A, Are the Taxpayers Getting What They Bargained For?*, Patrick Anderson listed the bills that were adopted by the legislature that increased the tax limits protected by the 3/4 vote limit. As of the end of 1996, there were already 10 bills that had varied the limits. One, SB 597, was vetoed by the governor. One increased an exemption (thus reducing taxes), and did not require a 3/4 vote. The other eight were tax increases, received a 3/4 vote, and were signed by the governor. Two of these, PA 173 and PA 278 of 1994, expanded school borrowing powers.

The report lamented the fact that many of these votes were taken without the legislature knowing that a 3/4 vote was required, and that only one chamber had adopted rules requiring such a vote.

10. Patrick L. Anderson, Nick Khouri; Memorandum to Governor John Engler, Michigan Department of Management and Budget, March 2, 1994. The table and text in the memo list, along with other laws, sections 1211, 1211a, 1211c, 1212, 1351a, 1356, and 1451 of the revised school code governing operating, enhancement, debt, sinking fund, and building & site millage.

**LEGISLATIVE RULES**

Both chambers of the legislature have now adopted rules that require the extraordinary vote for a change in the tax limits protected by Proposal A. House of Representatives Rule 55 requires a 3/4 vote on “Any law which increases the February 1, 1994, statutory limits on the maximum amount of ad valorem property taxes that may be levied for school district operating purposes. (See Const 1963, Art 9 § 3.)” Senate Rule 3.501 is similar.

*Bond, Building & Site, and Sinking Fund Millage*

The school aid act and revised school code establish funding for school operating purposes.<sup>11</sup> Since Proposal A, such funds have been explicitly allocated on a per-pupil basis. Proposal A further guaranteed minimum funding for every school district, again on an operating purposes, per-pupil basis.<sup>12</sup>

Bond, building & site, and sinking fund millages can be prudent vehicles to raise funds for capital projects. “Capital” projects are those that create long-term physical capital, such as buildings and land. Borrowing long-term to finance such capital can be prudent, much like a 30-year mortgage is a reasonable way for a family to buy a house. However, to allow them to be used as a supplement to operating millage is imprudent, if not reckless. Bonds that will take 20 years to repay should not be used to pay for services, nor for short-lived assets. Short-lived assets like school buses and “technology” have a useful life of three to seven years—imprudent expenditures for debts repaid over ten or twenty years.<sup>13</sup>

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11. Article VIII of the 1963 Michigan Constitution, the education article, begins with the words of the 1787 Northwest Ordinance, based largely on a plan authored by Thomas Jefferson: “Religion, morality and knowledge being necessary to good government and the happiness of mankind, schools and the means of education shall forever be encouraged.” The second section of the Article establishes the state legislature as the body responsible to “maintain and support a system of free public elementary and secondary schools as defined by law.” The school aid act and school code are the two main laws that “maintain ... schools as defined by law.”

12. Proposal A added these provisions to the end of Article IX, section 11, which also establishes the school aid fund and dedicates taxes to this fund. See also “The Taxes Funding Michigan Schools” on page 8.

13. The useful life of such expenditures can vary, but the Internal Revenue Code is a good guide. Sections 1245 and 1250 of the Code list cars, light and heavy duty general purpose trucks, qualified technology equipment, and computers and peripheral equipment as depreciable five-year property. See, e.g., *Master Tax Guide*, Chicago, Commerce Clearing House, various years; paragraph 1240.

The Internal Revenue Code tends to exaggerate the useful life of assets, as this approach increases tax collections. Many taxpayers expense immediately a good share of “technology” expenditures, noting that operating system and application software; computers and peripherals; and wiring, PDA’s, telecom equipment and accessories are often obsolete within two to three years.

To ensure that operating funds are not commingled with funds intended to be used for separate purposes, the School Code requires that school districts create budgets for operating, building & site, and debt millage separately.<sup>14</sup>

#### **BOND MILLAGE**

The most well-known of the non-operating millages is debt millage. Since passage of the “Headlee” amendment in 1978, taxes can be levied above and beyond operating millage limits to pay for principal and interest on bonds, if they have been approved by the voters.<sup>15</sup> This requirement matches the state constitutional requirement that the voters approve state “general obligation” debt.

The voter-approval requirement forces school districts to make the case for debt millage. While there have been some end-runs around this requirement (notably the invention of “limited tax general obligation bonds,”) this voter-approval requirement has been generally accepted.<sup>16</sup>

#### **BUILDING & SITE MILLAGE**

“Building & Site” millage was designed to allow segregated millage for the construction and major expenditures required by physical assets.<sup>17</sup> It is separate from operating millage.<sup>18</sup> However, to the extent that “building & site” millage pays for maintenance or other expenditures that should be paid from current revenues, it is actually a levy for operating purposes.

#### **“SINKING FUND” MILLAGE**

A sinking fund has a specific, technical meaning: it is a fund created and increased solely to repay principal on a debt.

An encyclopedia definition of the term is:

[A] sum set apart periodically from the income of a government or a business and allowed to accumulate in order ultimately to pay off a debt. A preferred investment for a sinking fund is the purchase of the government's or firm's bonds that are to be paid off.<sup>19</sup>

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14. Revised School Code, section 432; note that this section applies specifically to first-class districts.

15. Under Article IX section 6 of our Constitution, all property taxes are subject to a limit. The limits established by charter or general law for operating millage can be exceeded, provided the voters approve the levy of taxes to pay principal and interest on bonds. The limit for debt millage is established by the principal outstanding, rather than a rate.

16. For a discussion of the “limited tax” bonds, see the Anderson, et. al, *Report of the Blue Ribbon Commission on the Headlee Amendment*, Michigan Department of Treasury, 1994; also available at [www.andersoneconomicgroup.com](http://www.andersoneconomicgroup.com).

17. The Revised School Code, sections 622 and 1215, requires segregation of debt retirement and building & site millage proceeds from operating funds.

18. The General Property Tax Act, section 24e, defines “building and site” millage as distinct from operating millage and debt millage.

19. Found at [www.encyclopedia.com](http://www.encyclopedia.com). An identical entry is in *The Columbia Encyclopedia*, Sixth Edition. 2001, found at [www.bartelby.com](http://www.bartelby.com).

The notion of a “sinking fund” is that money is accumulated over time (sinking), so that when a lump sum comes due on a loan, the accumulated funds will be available. Michigan has allowed school districts to levy “sinking fund” millages to build up funds to pay for future capital projects, much like bond sinking funds are used to pay for past projects.

## *Changes Since Proposal A*

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Since Proposal A passed in 1994, the following changes have occurred:<sup>20</sup>

1. School funding has grown dramatically, and the gap between the lowest-spending and highest-spending school districts has become much smaller. In 1994, over four-fifths of Michigan’s school districts had less than \$5,400 per pupil in operating revenue, and two-fifths had less than \$4,500. By 2000, the *minimum* funding per student was \$5,400, and a good number of districts had spending of \$6,000 or more.<sup>21</sup>
2. The overall state-and-local tax burden, relative to other states, has become closer to the national average. Before Proposal A, Michigan had one of the highest property tax burdens in the country, and an overall tax burden that was significantly above the national average. Michigan’s overall tax burdens are now slightly higher than the national average.
3. The number of millage elections has fallen, and the share of those millage proposals presented to voters that pass has risen.
4. As a feature of Proposal A, school operating millage has declined. However, school building & site, debt, and sinking fund millage has grown dramatically. From 1994 to 1997, annual tax revenue from these millages grew from \$451.9 million to \$723.9 million—a 60% increase in just three years. By 2000, the tax revenue from these millages had grown to nearly \$1 billion—a 117% increase in tax revenue in just six years.<sup>22</sup> The average millage rate had grown during this short period from 2.6 mills to 4.1 mills. See Figure 1, “Changes in Price, Enrollment, and Taxpayer Funding Since “Proposal A”,” on page 5.

## *Recent Legislation*

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### **HOUSE BILL 4824**

House Bill No. 4824, introduced on May 24, 2001 and passing the House on December 13, 2001, calls for an amendment to the revised school code.<sup>23</sup> The bill would allow the levy of up to 5 mills on the taxable value of both real and personal

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20. Unless noted, the source data for these observations is *Proposal A: A Retrospective*, Michigan Department of Treasury, August 1998.

21. *Economic Report of the Governor, 2000*; “School Finance Reform,” page 62.

22. Tax revenue data from Michigan State Tax Commission. 2001 data were not available at the time of writing. See Figure 3, “Debt, Sinking Fund, and Building & Site Taxes,” on page 6.

23. The bill would amend section 1212 of the Code.

property for up to twenty years. Currently, this section of the revised school code authorizes a tax levy for the purpose of establishing a sinking fund. However, under the bill revenue generated from the taxes could be used for any purpose allowed for debt millage.<sup>24</sup>

Such a change in law would greatly increase the scope of projects that school districts could fund with such taxes. Although “sinking funds” were originally intended only to pay for capital expenses, the bill would allow “sinking fund” taxes to fund:

- Purchasing, erecting, completing, remodeling, or equipping or re-equipping school buildings, including library buildings, structures, athletic fields, playgrounds, or other facilities, or parts of or additions to those facilities.
- Furnishing or refurnishing new or remodeled school buildings.
- Acquiring, preparing, developing, or improving sites, or parts of or additions to sites, for school buildings, including library buildings, structures, athletic fields, playgrounds, or other facilities.
- Purchasing school buses.
- Acquiring, installing, or equipping or re-equipping school buildings for technology.
- Refunding all or part of existing bonded indebtedness if the net present value of the principal and interest to be paid on the refunding bonds, excluding the cost of issuance, will be less than the net present value of the principal and interest to be paid on the bonds being refunded, as calculated using a method approved by the Department of Treasury.
- Accomplishing a combination of the above purposes.<sup>25</sup>

Such a bill would encourage more school districts to seek voter approval of sinking funds, “and thus increase property taxes for residents approving these proposals”<sup>26</sup> and further erode the tax limitations adopted under Proposal A of 1994.

#### **OTHER PROPOSED CHANGES**

Several other bills dealing with school finance have been introduced by Michigan legislators in the last year. Among these bills are House Bill 4917, House Bill 4582, and Senate Bill 688. See Table 2, “Other Proposed School Tax Changes,” on page 14 for more information.

24. Section 1351a governs debt millage.

25. Revised School Code, 1976 PA 451, section 1351a.

26. Senate Fiscal Agency analysis of HB 4825.

**TABLE 2. Other Proposed School Tax Changes**

Bill No.	Bill Amending	Implications
HB 4917	1976 PA 451, section 1212	Would allow districts to levy additional millages under section 1211 to enhance operating revenues to levels of up to 2 times the State's per pupil allowance.
HB 4582	1976 PA 451	With voter approval, districts could levy up to 5 mills to create sinking funds to be used for real estate purchase, building construction or repair, or to "participate in paying for infrastructure improvements on public property or a public easement that directly impacts the use of school property..."
SB 688	1976 PA 451, section 1212	Would allow school districts to ask voter approval to levy up to 5 mills to create sinking funds for real estate purchase, construction, repair, and any other purpose allowed under 1351A.

*Source: Anderson Economic Group analysis of relevant bills.*

In addition to these statutory changes, a statewide bond issue has been proposed, which would create a fund—supported by state taxes—that would subsidize projects financed by the taxpayers of individual school districts. If approved by the voters of the state, and fulfilling its stated goal of encouraging and partially financing projects approved by the voters of local school districts, this would result in higher state taxes and higher local taxes.

While we have not projected the fiscal impact for these other proposals, the higher-millage scenario presented above for an expansion of "sinking fund" taxes alone provides an indication of the additional taxes that would arise from combining more than one legislative tax increase. See Table 1 on page 3.

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## *Fiscal Impact Methodology*

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The tax projections included in this report are based on specific assumptions about current taxable value, growth rates for taxable value, millages authorized under current and proposed laws, and voter behavior when confronted with future millage proposals.

### **COMPOSITION OF MILLAGE AND DISTRICTS**

The total revenue impact of future tax changes is largely determined by the total number of mills levied, rather than the composition of those mills. Therefore, a scenario that incorporates an assumption of 5 additional mills being levied in 50% of the districts would accurately predict the revenue impact of 5 building & site mills and no other new millage, 2.5 building & site mills and 2.5 debt mills, as well as 5 sinking fund mills and no other additional millage.

We describe the various scenarios partially by the share of districts that adopt certain millages. Of course, some districts have much larger tax bases than others, and therefore would generate more tax revenue. A scenario based on adoption of a certain millage rate by “50% of the districts” would be more accurately described as “districts having 50% of the state’s taxable value.”

### **MILLAGE SCENARIOS**

The least predictable of these variables is voter behavior. Therefore, we have provided a set of scenarios that cover the range of likely responses by voters to changes in law. Each scenario is reasonably conservative in assuming that changes occur gradually over a 10-year period.

To assess the impact of the proposed changes, a model was developed to simulate three millage growth scenarios. Each scenario assumes Senate and Executive approval of HB 4824, allowing districts to seek voter approval of “sinking fund” millages of up to 5 mills, and then spend the resultant revenue on purposes other than retiring debt. Our base scenario assumes an average increase of 2.5 mills, phased in over 10 years. Scenario two assumes an average increase of 1.5 mills, and scenario three assumes a 3.5 mill increase.

### **TECHNICAL ASSUMPTIONS**

We assume that 62% of the debt, sinking fund, and building & site millage is paid by residential taxpayers, and the remaining by businesses (including farms). This is based on the current-law provision that does not exempt homestead property from these millages, and from the share of total taxable value accounted for by residential real property.<sup>27</sup>

“Fiscal Impact Simulation Results” on page 16 describes the results of our simulations. In addition, see Table 3 on page 17, and Table 4 on page 18, for more detail on the simulation results and assumptions.

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27. Residential real property accounted for \$114 billion of the \$182 billion in statewide taxable value in 1995. While this ratio may have changed slightly, we have kept this a constant in our model. Source data: Michigan Department of Treasury, *The Michigan Real and Personal Property Tax*, March 1997, exhibit 8.

## *Fiscal Impact Simulation Results*

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The following summarizes the results of our simulations of an expanded school “sinking fund” tax:

**BASE SCENARIO: 2.5 MILL INCREASE**

Our base scenario assumes that “sinking fund” taxes grow at the same rate as debt, sinking fund, and building & site millage grew after the 1994 law expanded the allowable purposes for debt millage. Under this assumption, which implies an increase of 2.5 mills over ten years, an additional \$5.43 billion will be collected from Michigan taxpayers from 2003 through 2013.<sup>28</sup>

Residential taxpayers will foot \$3.37 billion of the total new taxes, and business and other non-resident tax sources will pay the remaining \$2.06 billion. Table 3, “Michigan School Finance Simulation Results,” on page 17 shows the impact in each of the ten years.

**SCENARIO TWO: 1.5 MILL INCREASE**

Our conservative estimate, scenario two assumes that the average statewide increase in sinking fund taxes will be 1.5 mills. Under this assumption, an additional \$3.26 billion in property taxes will be collected from 2003-2013. We project that \$2.02 billion of this amount will come from residential taxpayers, and \$1.24 billion will come from non-resident tax sources. See Table 3, “Michigan School Finance Simulation Results,” on page 17 for more detail on the impact.

**SCENARIO THREE: 3.5 MILL INCREASE**

Our more liberal estimate, scenario three assumes an 3.5 mill average tax increase over ten years.

Under this assumption, \$7.60 billion in additional taxes will be collected over a ten-year period, of which \$4.71 billion will be collected from residential taxpayers, and \$2.89 billion from non-residential sources. For more detail, see Table 3, “Michigan School Finance Simulation Results,” on page 17.

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28. As indicated in the table, a 2.5 mill increase over ten years means an 0.25 mill increase in the first year of the ten-year period, which is 2004, an 0.50 mill increase in 2005, leading eventually to a 2.5 mill increase in 2013. Each of the scenarios uses a similar ten-year straight-line implementation schedule.

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**Table 3. Michigan School Finance Simulation Model Results**

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**Base Scenario: 2.5 Mills Average Increase**

	Cumulative Millage Increase	Annual Property Tax Increases (in billions)	Residential Burden Increase (in billions)	Non-Residential Burden Increase (in billions)
2003	0.00	\$ -	\$ -	\$ -
2004	0.25	\$ 0.07	\$ 0.05	\$ 0.03
2005	0.50	\$ 0.15	\$ 0.10	\$ 0.06
2006	0.75	\$ 0.24	\$ 0.15	\$ 0.09
2007	1.00	\$ 0.34	\$ 0.21	\$ 0.13
2008	1.25	\$ 0.44	\$ 0.28	\$ 0.17
2009	1.50	\$ 0.56	\$ 0.35	\$ 0.21
2010	1.75	\$ 0.69	\$ 0.43	\$ 0.26
2011	2.00	\$ 0.82	\$ 0.51	\$ 0.31
2012	2.25	\$ 0.97	\$ 0.60	\$ 0.37
2013	2.50	\$ 1.13	\$ 0.70	\$ 0.43
<b>SUM</b>		<b>\$ 5.43</b>	<b>\$ 3.37</b>	<b>\$ 2.06</b>

**Scenario 2: 1.5 Mills Average Increase**

	Cumulative Millage Increase	Annual Property Tax Increases (in billions)	Residential Burden Increase (in billions)	Non-Residential Burden Increase (in billions)
2003	0.00	\$ -	\$ -	\$ -
2004	0.15	\$ 0.04	\$ 0.03	\$ 0.02
2005	0.30	\$ 0.09	\$ 0.06	\$ 0.04
2006	0.45	\$ 0.15	\$ 0.09	\$ 0.06
2007	0.60	\$ 0.20	\$ 0.13	\$ 0.08
2008	0.75	\$ 0.27	\$ 0.17	\$ 0.10
2009	0.90	\$ 0.34	\$ 0.21	\$ 0.13
2010	1.05	\$ 0.41	\$ 0.26	\$ 0.16
2011	1.20	\$ 0.49	\$ 0.31	\$ 0.19
2012	1.35	\$ 0.58	\$ 0.36	\$ 0.22
2013	1.50	\$ 0.68	\$ 0.42	\$ 0.26
<b>SUM</b>		<b>\$ 3.26</b>	<b>\$ 2.02</b>	<b>\$ 1.24</b>

**Scenario 3: 3.5 Mills Average Increase**

	Cumulative Millage Increase	Annual Property Tax Increases (in billions)	Residential Burden Increase (in billions)	Non-Residential Burden Increase (in billions)
2003	0.00	\$ -	\$ -	\$ -
2004	0.35	\$ 0.10	\$ 0.06	\$ 0.04
2005	0.70	\$ 0.22	\$ 0.13	\$ 0.08
2006	1.05	\$ 0.34	\$ 0.21	\$ 0.13
2007	1.40	\$ 0.47	\$ 0.29	\$ 0.18
2008	1.75	\$ 0.62	\$ 0.39	\$ 0.24
2009	2.10	\$ 0.78	\$ 0.49	\$ 0.30
2010	2.45	\$ 0.96	\$ 0.60	\$ 0.37
2011	2.80	\$ 1.15	\$ 0.71	\$ 0.44
2012	3.15	\$ 1.36	\$ 0.84	\$ 0.52
2013	3.50	\$ 1.59	\$ 0.98	\$ 0.60
<b>SUM</b>		<b>\$ 7.60</b>	<b>\$ 4.71</b>	<b>\$ 2.89</b>

Source: Anderson Economic Group

## Table 4. School Finance Model Data

### Millage Growth Scenarios

<u>Variable Name</u>	<u>Variables</u>	<u>Units</u>	<u>Values</u>
<b>Tax Related Variables</b>			
Statewide_TV	Statewide Taxable Value of Property	Sbillions, 2000	\$ 241
TV_growth	Taxable Value annual growth rate	%	5
Res	Residential Property with Homestead Exemption (as portion of total taxable value)		0.62
BSM	BSM millage authorization	mills	-
debt	Debt millage authorization	mills	-
SF_1	Sinking Fund millage authorization (low case)	mills	1.5
SF_2	Sinking Fund millage authorization (base case)	mills	2.5
SF_3	Sinking Fund millage authorization (high case)	mills	3.5

### Portion of School Districts Levying Selected Millage (at end of forecast period) -- Different Scenarios

BSM_app	BSM Apportionment - portion of school districts levying by end of forecast period	100%
debt_app	debt Apportionment	100%
SF_app	SF Apportionment	100%

### Simulation Parameters

Tstart	Model Start Time (year)	2,003
Tstop	Model Stop Time (year)	2,013
Tstep	Model Increments	1

### Implementation Schedule

Years>	2003	Schedule>	0%
	2004		10%
	2005		20%
	2006		30%
	2007		40%
	2008		50%
	2009		60%
	2010		70%
	2011		80%
	2012		90%
	2013		100%

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## *Policy Alternatives*

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There are alternatives to the proposed expansion of sinking fund taxing authority. These alternatives include:

### **RETAIN PROPOSAL A**

Proposal A has been an unqualified success at its key objectives: reducing local school property taxes, increasing funding for schools, and reducing the difference between the highest- and lowest-spending school districts.

The first alternative, therefore, is to retain the current statutory tax limits protected by the Constitutional provisions established by Proposal A.

### **CONSIDER REGIONAL TAXES**

Current law already provides for school districts to join together in asking voters to increase local taxes to augment spending for operating purposes. The law allows for up to 3 mills of taxing authority, on an intermediate school district-wide basis.

If the voters agree that more money is necessary, and that additional funds need to be expended for operating purposes, this option is already available.

### **PROHIBIT “DOUBLE DIPPING”**

Current law allows for school districts to support true capital expenditures through debt millage, or sinking fund millage. Taxpayers rightly are concerned that levying both debt and sinking fund millage would be “double dipping” for capital purposes, since these are different ways of financing the same type of expenditure.

To prevent this, the legislature could amend the school code to prohibit school districts from levying any new “sinking fund” millage until outstanding debt obligations were retired or defeased.<sup>29</sup> It could similarly prohibit any new debt millage when a sinking fund millage was also levied.

### **TIGHTEN ALLOWABLE PURPOSES FOR DEBT MILLAGE**

Another common-sense reform would be to tighten the allowable purposes for which “debt” millage could be expended. As indicated in “Bond, Building & Site, and Sinking Fund Millage” on page 10, the current statute allows “debt” millage to be used to fund certain operating expenditures. Taxpayers should be wary of voting upon themselves taxes to be repaid over the next ten or twenty years, when the money is used to buy services, maintenance, or short-lived assets like school buses—let alone undefined concepts such as “technology.”

Such a reform would not only improve fiscal prudence, it would also increase the confidence voters would have in future debt millage proposals.

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29. “Defeasing” the debt would be accomplished by purchasing US Government obligations or other very safe investments, in amounts sufficient to repay the debt, and putting them in a separate, segregated account. This is the traditional purpose of a “sinking fund.”

**EXPAND CHARTER SCHOOLS**

Public school academies, commonly known as “charter schools,” are public schools that operate under a charter from a public body. Such schools receive a per-pupil allowance for operating purposes.

Unlike traditional school districts, however, charter schools have no independent taxing authority, and cannot levy debt, sinking fund, or building & site millage. Therefore, they are forced to support both operating and capital expenditures within the per-pupil operating amount.

If state law is changed to effectively create an additional source of operating funds—by expanding the uses of “sinking fund” or other taxes—it would have the additional effect of increasing the existing disparity in funding between public school academies and traditional public school districts.

Overall enrollment within the public school system in the state has been relatively stable, and has grown much more slowly than funding.<sup>30</sup> However, in some areas of the state declining or expanding enrollment can challenge existing school districts.<sup>31</sup> Should such school districts find it difficult to handle the demands on their facilities within their per-pupil operating funds and their capital funds, they could encourage charter schools to educate a portion of the students in the area. The lower total per-pupil expenditures in charter schools would mean a larger amount of per-pupil capital funds available to the traditional public school district.

**INSIST ON BETTER MANAGEMENT**

The need for school districts to properly manage their funds is often overlooked in discussions of capital expenditures. In a properly managed school district, like a properly-managed household or business, maintenance and other needed expenditures are made out of current revenue. Painting, maintaining roofs and siding, occasional remodeling and refurbishing, and other such expenditures are commonly supported by household and business budgets. A well-managed school district will do the same.

It is difficult to legislate a concept such as “good fiscal management.” However, the legislature and the state superintendent of schools should consider ways to encourage, or require, that school districts allocate an appropriate amount of their operating revenue each year to the repair, maintenance, and refurbishing of their existing school buildings. This would prevent “crises” occurring due to the lack of repairs or other poor management practices in the past.

School districts should also consider management practices that improve the efficiency of their non-instructional expenditures. Practices proven to save money

30. See Figure 5, “School Operating Revenue vs. Enrollment,” on page 7.

31. Because the state guarantees funding on a per-pupil basis, schools with declining or increasing enrollment receive operating funds that closely match their enrollment changes. However, facilities cannot be erected or sold rapidly, so districts with unexpected, significant changes in enrollment do face additional costs related to either more facilities than needed, or the need for new facilities.

include competitively bidding health care insurance; and outsourcing services such as janitorial, transportation, and maintenance.

### *About the Michigan Chamber Foundation*

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The Michigan Chamber Foundation is the sponsor of this study and subsequent report. The Foundation serves a number of purposes, including:

- To plan and conduct nonpartisan public education programs regarding free enterprise, productivity and basic economic issues affecting the State of Michigan.
- To conduct nonpartisan research and distribute policy studies on issues facing Michigan including, but not limited to, taxation, government regulation, health care, hazardous waste, crime, tourism and recreation, welfare, government spending and transportation.
- To engage exclusively in activities for charitable, scientific, educational, and other purposes as defined in section 501(c)(3) of the Internal Revenue Code.

The Foundation believes that the findings of the study are critical, and will help policy makers and Legislative leaders make well-informed decisions and create sound policy.

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## Project Team

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The principal author of this study is Patrick L. Anderson, Managing Director of Anderson Economic Group. He was assisted by Scott D. Watkins, Analyst; and Ilhan Geckil, Economist. Their backgrounds are summarized below.

### **PATRICK L. ANDERSON**

Mr. Anderson is the Founder and Managing Director of Anderson Economic Group, and a principal in the BBK firm. He supervises the public policy and economics consulting practice of the firm, and has successfully directed projects with a wide range of state and local governments, nonprofit organizations, and private corporations.

Prior to founding Anderson Economic Group, Mr. Anderson served as the chief of staff of the Michigan Department of State, and as a deputy director of the Michigan Department of Management and Budget. Prior to his involvement in State Government, Mr. Anderson was an assistant vice president of Alexander Hamilton Life Insurance, where he shared responsibility for \$5 billion in invested assets, and was an economist for Manufacturers National Bank of Detroit.

Mr. Anderson has written extensively on a number of topics involving economics and public policy. He has had over eighty-five articles published in periodicals such as *The Wall Street Journal*, *The Detroit News*, *The Detroit Free Press*, *American Outlook*, *Crain's Detroit Business*; and monographs published by the Mackinac Center for Public Policy, The Economic Enterprise Foundation of Detroit, the Ethan Allen Institute in Vermont, and the Heartland Institute of Chicago.

Mr. Anderson is a graduate of the University of Michigan, where he earned a Masters degree in Public Policy and a Bachelors degree in Political Science. He is an Adjunct Fellow with the Hudson Institute, and a member of the National Association for Business Economics.

### **SCOTT D. WATKINS**

Mr. Watkins is an Analyst with Anderson Economic Group. He has extensive background in performing technical and policy research, creating market reports, and analyzing market and demographic data. Prior to joining the firm, Mr. Watkins was an Analyst in the automotive market and planning group at J.D. Power and Associates, where he contributed to research and analysis for clients including General Motors Corporation, Ford Motor Company, DaimlerChrysler Corporation, Bosch, and Johnson Controls. Mr. Watkins also held a marketing assistantship with Foster, Swift, Collins, and Smith P.C.

Mr. Watkins is a graduate of Michigan State University with a B.A. in Marketing from Eli Broad College of Business and a B.A. in International Relations from the James Madison College.

### **ILHAN K. GECKIL**

Mr. Geckil is a Consultant with Anderson Economic Group, with expertise in economic and fiscal modeling, and advanced statistical & econometric analysis. Prior to joining the firm, Mr. Geckil served as an assistant consultant for the Project Development and Financial Consulting Corporation in Istanbul, Turkey; as an intern with Arthur Andersen, Istanbul, Turkey; and as a research assistant at Michigan State University.

Mr. Geckil holds a Masters degree in Economics from the Eli Broad Graduate School of Management at Michigan State University, and Bachelor degrees in Economics and International Relations from KOC University in Istanbul, Turkey. He is a member of National Association for Business Economics, and Strategy Forum.