Efforts to Fix Local Government Revenue Raising Model

Addressing the Interaction of the Headlee Amendment and the Taxable Value System

Various voices will assign different perspectives to the problems of Michigan's local government revenue raising model.

1. **The taxable value system taxes properties that are alike in many ways at different levels based on tenure of ownership.** Equity has been impacted by the tax limitations. Proposal A has affected individual taxpayers differently depending on how long they have owned their properties increasing inequity with taxpayers in similarly valued homes having very different property tax burdens. It also has created incentives to retain ownership, because property owners may experience substantial increases in their tax burdens due to the pop-ups, even when downsizing to smaller, lower valued properties.

   These inequities and the perverse result of keeping people in their homes when they might otherwise downsize are integral parts of a tax system based on the modified acquisition value system (taxable value) that will only be remedied by abandoning that system. Other states have implemented workarounds, but this only makes the system worse.

2. **The overlapping property tax limitations (Section 31 of the Headlee Amendment and the taxable value system) are too restrictive in the growth of property tax revenues.** For those local governments whose property values were adversely affected by the Great Recession, the annual growth rate for the scenario with both tax limitations in the post-recession period is slower than what was experienced in the pre-recession period. Those post-recession revenues are not keeping pace with the rate of inflation. The relationship between the appreciation of property values and tax revenues is diminishing.

   Policy Options

   a. **Renew Headlee rollups.** Among other changes, the Headlee Amendment added Article IX, Section 31 to the Michigan Constitution, limiting local property taxes in two ways. First, it requires voter approval to adopt a new tax and to increase the rate of an existing tax above what was authorized in 1978 (the year the amendment was adopted). Second, it limits total property tax revenue growth on a jurisdiction-wide basis (e.g., city, township, village) to the rate of inflation.

      This limit is applied by requiring local governments to downwardly adjust ("rollback") the maximum authorized rate if the tax base increases by a larger percentage than the cost of living (i.e., inflation), as measured by the Consumer Price Index (CPI). Calculation of the tax rate change is made back calculating the millage reduction fraction (MRF). It is applied to the previous year's maximum authorized rate. This fraction is the ratio between assessment growth and the growth in the price level, adjusted to exclude new construction. It is calculated

by subtracting losses from the previous year's property values and multiplying that by the CPI, then dividing that figure by the current year's property values minus additions:

$$\text{Millage Reduction Fraction} = \frac{(\text{last year's TV} - \text{losses}) * \text{CPI}}{(\text{current year's TV} - \text{additions})}$$

When the Headlee Amendment was originally implemented, Headlee rollups existed as well. In years in which assessment growth lagged the inflation rate, the MRF could exceed one and therefore increase the rolled-back millage rate (it could never increase above the originally authorized rate). This practice was prohibited by the law that triggered the school finance reforms voted on as Proposal A of 1994. According to some, the allowance of non-voted rollups in the maximum authorized rates of property taxation was questionable and possibly contrary to the Constitution though the issue was not adjudicated in the 15 years that Headlee rollups were allowed.

This is a policy that would have been nice to have during the Great Recession. Jurisdiction-wide property values tend to be stable, so it is not clear how valuable this policy would be in the future (let's hope we don't repeat the loss of property values or the other disruptions of the Great Recession any time soon).

Implementation could be done statutorily.

b. **Eliminate the tax rate rollback provisions from the Headlee Amendment.** The tax rate rollback provisions of the Headlee Amendment became superfluous with enactment of the taxable value system. Both are designed to accomplish the same thing – limiting growth of property tax revenues to the rate of inflation.

   Article 9, Section 31 provides for the rollbacks and the vote requirement for new taxes or tax rate increases. Change should be surgical, not just eliminating Section 31.

   This would require a constitutional amendment.

c. **Exclude pop-ups from the calculation of millage reduction fraction.** The modified acquisition value system constrains appreciation to the rate of inflation. When ownership of property is transferred, TV is uncapped and allowed to pop up to SEV. With growth of the taxable value of all properties that do not change ownership constrained to the rate of inflation, the pop-up in values trigger Headlee Amendment tax rate rollbacks across a jurisdiction's entire tax roll.

   Many urban and suburban communities are largely built out, but they have redeveloped land and revitalized neighborhoods and downtowns to invest in their communities. The problem is that they do not see tax revenue growth from this type of investment because Proposal A restricts tax revenue growth to additions and sales; increases from investment in property cannot increase TV beyond inflation. When property is sold and its assessed value is reverted to SEV, the Headlee Amendment treats that pop-up as revenue growth and requires the

millage rate to be rolled back. This is preventing communities with turnover in their properties from benefitting from those sales and increases in property values.

The overall point is that the system is not sustainable if the growth of property tax revenues relies on new development. This system leaves no room for revitalization and redevelopment and encourages urban sprawl. If local governments do not see the revenue benefits from investing in their community, it is hard to maintain that investment.

Vibrant communities depend on tax systems that allows the communities to benefit from their own revitalization while also protecting taxpayers from unlimited growth and unpredictability in their property taxes.

This could be addressed by changing the calculation of the millage reduction fraction to exclude properties that have experienced a change in ownership, and therefore a pop up to the SEV, in the prior year. This would serve the taxpayers by limiting the growth of their tax burdens, but would allow the local governments to benefit from healthy real estate markets and redevelopment of property.

The Millage Reduction Fraction is a statutory creation and can be altered legislatively.

d. **Change the measure of taxpayers' ability to pay property taxes from inflation to personal income.** The Headlee Amendment used inflation as a measure of economic growth for property tax revenue affecting local governments but personal income to measure the change in state generated revenue. Both aim to limit growth of the tax burden to the ability of taxpayers to pay the tax.

   For a number of economic and inflation measurement process reasons, inflation is a very constrained measure of economic change. Personal income has not grown at significantly fast rates, but at a rate faster than inflation. A change to personal income for property tax growth would allow a little more year-to-year growth in revenue, but still provide taxpayer protection.

   Change would require a constitutional amendment and statutory implementation.

3. **The local government revenue raising model has lost relationship to economic change, in aggregate and for individual local governments.** Michigan began suffering from economic troubles shortly after Proposal A of 1994 was implemented, severely affecting state revenues. One policy response was to severely reduce state revenue sharing distributed to local governments. In combination with the interaction of the two property tax limitations, local government revenues have lost much of their relationship with economic change.

   The diminished relationship between property values and the tax base is most pronounced for rural communities. Ownership of agricultural property changes less often than for residential, commercial, or industrial property, which is leading the TV of

agricultural properties to pop-up to SEV less frequently than is occurring in urban and suburban communities.

The diminished relationship is less stark but still significant in urban and suburban communities because the pop-ups for properties transferring ownership cause tax rate rollbacks and less than inflationary growth from their existing tax bases.

Policy Options

a. **Renew Headlee rollups and exclude pop ups from calculation of MRF.** These reforms would restore some relationship of property tax revenues to economic growth, but the change would be marginal.

   The root of the problem is that Michigan local governments rely almost exclusively on the property tax as the primary source of revenue. Property taxes are by their very nature a slow growing, stable source of revenue.

b. **Authorize alternative local-option taxes.** Michigan cities are authorized to levy income taxes and various taxes are authorized to counties, but Michigan pales in comparison to other states in the menu of revenue raising options available to local governments. Local-option sales, income, utility users excise, entertainment, vehicle registration, motor fuel, and other taxes would provide ties to economic activity and reward local governments successful at providing quality places attractive to families and businesses.

   In addition to creating ties to economic activity, these taxes would allow for property tax rate reductions that would help to make Michigan's cities more attractive places to locate.

   The Michigan Constitution provides for local-option taxes, but the legislature quickly enacted a law requiring statutory authorization before a local-option tax could be utilized. Most local-option taxes could be authorized statutorily, but a local-option sales tax would require a constitutional amendment. All would require a vote of the residents in each jurisdiction for implementation.

c. **Authorize a local-option sales tax.** Michigan is one of 13 states without local-option sales taxes. It would require a constitutional amendment, statutory authorization, and a vote of the residents.

d. **Fund state revenue sharing.** With 1800+ local governments and relatively few services provided by counties or regions, actually implementing local-option taxes if they were authorized would be politically difficult. Revenue sharing could serve the same purposes. It provides administrative efficiency in the collection of taxes and minimizes the political dynamic of a single local government becoming uncompetitive if it votes to levy a tax, but neighboring communities do not. Fully funding revenue sharing according to constitutional and statutory earmarks would relieve some of that pressure. This a budgetary and policy decision.