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## Michigan at a Crossroads

# Local governments in Michigan: Current Trends and Future Challenges

## A Guide for the 2019 Incoming Gubernatorial Administration

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# Local Government Overview

The term "local governments" refers to a group of entities with wide diversity. There are 90,056 local governments in the US, including 3,031 counties, 19,519 municipalities, 16,360 townships, 38,266 special districts, and 12,880 independent school districts.[1] Unlike special districts and school districts that perform a limited number of functions, counties, municipalities (including cities and villages), and townships are general-purpose governments that provide a wide variety of public services including financial administration, hospitals, police and fire, highway administration, just to name a few. In many ways, these governments remain the backbone of the American federal system. At the same time, local units of government are creatures of the states and the state government provides oversight for local units and is accountable for local residents' wellbeing.

Regionally, the Midwest has the highest number of local governments; Michigan is no exception. There are 83 counties, 1,242 townships, 274 cities, 259 villages, and 553 school districts in Michigan.[2] The jurisdictions of these local governments overlap – two residents can live in different townships in the same county, and their children can go to different public schools. As a result, residents living in close proximity can receive different public services provided by different units of government.

Although government decentralization, manifested by the diverse local units, is designed to be more responsive to diverse needs and demands of local residents, it can also create challenges for governance. Even prior to the Great Recession of 2008-09, there was a clear understanding of the financial problems facing local governments.[3] Since that time and post-Great Recession, Michigan local governments have experienced severe fiscal distress that has only recently lessened although not for every local unit. The purpose of this brief is to provide a tour of the current financial and service landscape of local governments in Michigan and discuss state policies impacting local finance.

1 Hogue, Carma, Government Organization Summary Report: 2012, Governments Division Briefs (September 26, 2013), at https://www.census.gov/content/dam/Census/library/publications/2013/econ/g12-cg-org.pdf.

2 Revised and updated in 2003 by William Steude, Municipal Report: Organization of City and Village Government in Michigan, Handbook for Charter Commissioners: Resource Materials for Village Charter Revision, at https://www.mml.org/pdf/charter_revision/village7.pdf.

3 Final Report to the Governor, The Task Force on Local Government Services and Fiscal Stability, May 2006, at https://www.michigan.gov/documents/FINAL_Task_Force_Report_5_23_164361_7.pdf.

# Current Status of Local Financial Condition

Several recent reports shed some light on both the data driven and self-reported financial status of Michigan local governments. The general context is that there have been significant improvements since the Great Recession but important areas of risk remain and a number of communities remain near fiscal insolvency even as the economy has improved.

## Self-Reported Financial Status

One source of self-reported information is the University of Michigan's Center for Local, State, and Urban Policy Michigan Public Policy Survey.[4] The latest survey results were released in November of 2018.

Local government leaders generally report that the financial health of their jurisdictions are slowly recovering from the recession. Some, around 16%, state that "they are less able to meet their needs this year, the lowest percentage since MPPS tracking began in 2009." Larger jurisdictions have improved the most. In contrast, smaller, more rural jurisdictions reported higher fiscal stress levels.

The report is optimistic about the future for Michigan's local government fiscal health, short term. Long term projections are a different story. Fifty-five percent of local officials are optimistic and expect improvements next year. This is a slight increase from the 51% who said this last year. "But in other continuing trends, fewer (34%) believe this will translate to improved fiscal health for their local governments, and more expect their levels of fiscal stress will worsen over the next five years."

As stated earlier, there remain a number of local units whose short-term financial picture is quite cloudy. The report states, "local leaders in 8% of Michigan jurisdictions—approximately 149 local governments—say they are currently experiencing relatively high levels of fiscal stress" and that number has remained the same in the past few years.[5]

## Results from Local Financial Reporting

A second report released in Fall 2018, based on reported data from local financial audits, comes from the Michigan Department of Treasury.[6] This report discusses the impact the recession and post-recession economy had on Michigan local government and those governments' fiscal health. Local government fiscal health is tied to the overall economy and is heavily dependent on property tax revenues, especially in a state like Michigan where there are so few local government revenue raising tools available. The Great Recession hit Michigan hard and Michigan has not recovered as quickly as other states, nor have Michigan local governments. There has been gradual improvement in terms of property tax revenues coming in, but there has not been enough improvement to make up for what was lost in the past 20 years (with both the 2001 recession and the Great Recession).

Short term improvements can be seen in higher general fund balances, fewer general fund deficit elimination plans and improved overall operating margins.[7] Even though there has been improvement in the short term, the report shows that long term liabilities are a problem for many local governments including deferred infrastructure maintenance and pension and retiree health care liabilities that amount to nearly $18 billion. The report also highlights that several dozen communities remain at risk of fiscal insolvency echoing the earlier reporting from the University of Michigan survey findings.

## Challenges of Local Service Insolvency

Finally, a 2017 report by the Michigan State University Center on Local Government Finance and Policy highlights the challenges many local governments are having in continuing to deliver an adequate level of public service to their residents. In this paper, a framework to evaluate the ability of Michigan cities ability to provide an adequate level of public services was developed.[8] This was a first step to move beyond fiscal solvency, as thought about in the reports above, and begin thinking about the ability to adequately provide services.

The ability of a local government to deliver public services depends on a number of factors: their property tax base per capita (taxable value per capita), the millage rate levied (which is limited to 20 mills for charter cities, and for many cities is less due to the constitutional provision that requires the millage rate to be reduced if property tax collections exceed the rate of inflation), the unrestricted General Fund balance which may be used to supplement spending during periods of weak revenue growth, and state revenue sharing payments. The framework

4 The survey is sent annually from 2009 to 2018 in order to collect local government leaders' assessments of their governments' fiscal condition as well as prospective actions the leaders will take to make the local government healthier. (Debra Horner, Natalie Fitzpatrick, and Thomas Ivacko, *Despite Sustained Economic Growth, Michigan Local Government Fiscal Health Still Lags*, Center for Local, State, and Urban Policy Gerald R. Ford School of Public Policy, University of Michigan, November 2018.)

5 Debra Horner, Natalie Fitzpatrick, and Thomas Ivacko, *Despite Sustained Economic Growth, Michigan Local Government Fiscal Health Still Lags*, Center for Local, State, and Urban Policy Gerald R. Ford School of Public Policy, University of Michigan, November 2018.

6 Fiscal Health of Michigan's Local Governments: Update since the Great Recession, Michigan Department of Treasury, Fall 2018, at https://www.michigan.gov/documents/treasury/Fiscal_Health_of_Michigans_Local_Governments_2018_638566_7.pdf.

7 Fiscal Health of Michigan's Local Governments: Update since the Great Recession, Michigan Department of Treasury, Fall 2018, at https://www.michigan.gov/documents/treasury/Fiscal_Health_of_Michigans_Local_Governments_2018_638566_7.pdf.

8 Robert Kleine and Mary Schulz, Service Solvency: An Analysis of the Ability of Michigan Cities to Provide an Adequate Level of Public Services, MSU Extension White Paper, Center for Local Government Finance and Policy, September 2017, at http://msue.anr.msu.edu/uploads/235/75790/GMI_062_Service_Solvency_Report-9-2017.pdf.

uses four criteria to determine if a city is likely to be service insolvent or on the verge of serve insolvency:

› A GF spending level that is 75% or less of the group average
› A TV per capita of less than $20,000
› A millage rate of 20 mills or more
› A GF balance of less than 2 months of GF expenditures

Revenue sharing was not used as a criterion as most cities have been affected in a similar manner.

Michigan has had more cities under state receivership/ supervision than any other state, as many of Michigan's cities are suffering from fiscal stress. There are three major reasons for this. First, the Great Recession devastated property values in Michigan. From 2008 to 2012, the taxable property value (TV) of cities fell 18.1%. Since 2012, the TV of cities has increased only 0.3% despite the economic recovery. The main reason for this slow recovery is the constitutional cap on taxable value, which limits the increase to 5% or the rate of inflation, whichever is less. Second, the state cut revenue sharing payments to cities by 14.6% from 2008 to 2015. Third, Michigan places more revenue raising restrictions on cities than almost any other state.[9]

One conclusion drawn from the analysis is that cities with TV per capita much below $20,000 will, in most cases, struggle financially and provide a less than desirable level of services. Cities in southeast Michigan are generally under more fiscal stress than cities in other parts of the state, mainly because the auto industry is concentrated in this region, and this is where most of the larger, older cities are located. From 2008 to 2012, TV declined by more than 20% in 68 cities and all but two of these cities are located in southeast Michigan.

Reviewing the findings on fiscal health and distress, there have been some improvements since the Great Recession but many locals remain below where they were in 2000 and some are at the brink of fiscal insolvency even in a good economy.

9 Joshua Sapotichne, et al., Beyond State Takeovers, MSU Extension White Paper, 2015 at http://msue.anr.msu.edu/uploads/resources/pdfs/beyond_state_takeovers.pdf.

# Home Rule and Preemption

With this backdrop, one important policy question is what role decentralization and home rule should play in Michigan going forward. Traditionally, Michigan has been known as a strong home rule state. However, that has not always translated in terms of fiscal autonomy or fiscal home rule. This is an important issue in regards to fiscal matters because each state in the country must decide on whether local units will be financed via their own source revenues from their local tax base or will be financed via transfers from the state tax base. Each approach has its own advantages and disadvantages. Michigan over the past two decades has created a system where state resources have been cut and local resources have been restricted, which, it could be argued, has led to a series of problems even given some of the short term improvements.

The United States Constitution does not suggest what type of authority local governments should possess (in fact, local governments are not mentioned at all). The Tenth Amendment reserves the powers of granting local authority to the States or to the people. The cornerstone of American municipal powers is originated from the case of *City of Clinton v. Cedar Rapids and Missouri River Railroad* (1868), also known as Dillon's Rule.[10] In this case, Judge Dillon summarized his view of the relationship between the state and local governments that "Municipal corporations owe their origin to, and derive their powers and rights wholly from, the legislature." That is, a local unit of government can exercise only the powers explicitly granted to them in state laws.

However, Dillon's Rule greatly limited local governments' ability to respond to local conditions, and required local officials to lobby the state legislature for more local authority. As a result, many states began to adopt "home rule" provision in the early 1900s. Home rule is a delegation of power from the state to its sub-units of governments. It refers to a state constitutional provision or legislative action that provides a local government with self-governance ability[11]

It is important to note although home rule provides local units with greater autonomy, the power is limited to specific fields. In many states, local policies made under the home rule status are only valid when they are not contradictory to state laws. Also, home rule is subject to judicial interpretation. This is different from Dillon's Rule, which is a standard of statutory construction - a court must not impose its own interpretation on a statute but should defer to the legislature to ascertain the legislative intent.[12]

Related to limits on local autonomy is state preemption. Preemption is a way state government limits local government autonomy by nullifying a municipal ordinance or authority.[13] When a state legislature preempts an issue, such as a specific tax on specific goods, this prevents local government constituents from voting on that local issue. According to a state-by-state analysis on preemption conducted by National League of Cities (2017), Michigan is among the states that has a wide span of preemption, including minimum wage, paid leave, ride sharing, municipal broadband, and property tax-raising capacity (more

10 *City of Clinton v. Cedar Rapids and Missouri River Railroad Co.*, 24 Iowa 455 (1868).

11 Black, Henry Campbell, Bryan A. Garner, and Becky R. McDaniel. 1999. Black's Law Dictionary. Vol. 196. West Group St. Paul, MN.

12 Jesse Richardson, Jr., Dillon's Rule Is from Mars, Home Rule Is from Venus: Local Government Autonomy and the Rules of Statutory Construction, Publius: The Journal of Federalism 41 (4): 662-85 (2011).

13 City Rights in an Era of Preemption: A State-by-State Analysis, National League of Cities, April 2, 2018, at https://www.nlc.org/resource/city-rights-in-an-era-of-preemption-a-state-by-state-analysis

discussion on this below). For example, local governments in Michigan cannot provide communications services unless they can provide proof that the local incumbent telecommunication service provider cannot or will not provide broadband to the community. Michigan also bars local governments from regulating plastic bags.

## Limits on Local Fiscal Autonomy

A specific focus on the limits on fiscal autonomy and fiscal home rule helps illuminate the ongoing fiscal challenges of Michigan local governments.

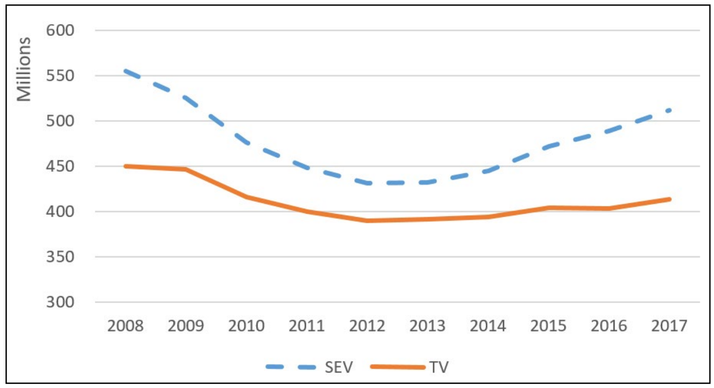
**Headlee Amendment.** In 1978, Michigan voters approved an amendment to the Michigan Constitution known as the Headlee Amendment. It created several new laws related to local government taxation. Given local governments' reliance on property tax, the major impact of Headlee amendment lies in the limitation it imposes on local property tax efforts. Based on Headlee Amendment, if the assessed value of all taxable property of a local tax unit increases at a rate faster than the inflation, the maximum property tax millage must be reduced so that the local unit's taxable property yields the same revenue. The new millage rate that adjusts for the increase in assessed value is known as a Headlee rollback.

**Proposal A.** In 1994, Michigan voters approved the Michigan education finance amendment, known as Proposal A. Motivated to address residents' frustration over high property taxes and inequities in funding for local school districts, the impact of Proposal A goes beyond the realm of educational finance. While it provides all local school districts with a minimum foundation allowance per pupil to lower the spending gap between low and high spending districts, it also decreases the amount of property taxes paid by Michigan residents.

Proposal A created a new value known as the "taxable value (TV)" for tax purposes. Each parcel now has a state equalized value (SEV) and a TV. SEV is the assessed value of all properties of a local tax unit; since assessments are set at 50 percent of the true cash value of each property, the change of SEV reflects the change of local housing market. TV is the base to which millage rate is applied for calculating property tax. Proposal A limits the growth of TV is capped at the lesser of inflation or 5 percent. In 1994, each property's SEV equaled its TV. Through time, due to rising housing prices, the growth of SEV has outpaced the growth of TV; however, due to the limit on TV, the housing market growth does not translate into a proportionate growth of local property tax revenue.

Figure 1 illustrates the gap between SEV and TV from 2008 to 2017. Each line represents the average SEV or TV across all counties, cities, and townships in a given year. It is evident that there is a gap between SEV and TV. SEV declined between 2008 and 2011 in response to the recession, but started climbing up after 2012. While the change of SEV reflects the improved economy, the growth of TV remains stagnant due to the limit imposed by Proposal A. The gap between SEV and TV further widens after 2014, when the housing price enjoys a rapid growth while TV is capped at inflation.

**Figure 1: Average SEV and TV from 2008 to 2017**




## State revenue sharing (SRS)

Besides, local taxation options, Michigan local governments also rely on the state to transfer funds primarily from the state sales tax. These transfers are generally thought of in lieu of a local sales tax option.

State budget for fiscal year 2019 recommends 1.3 billion for state revenue sharing. Local governments in Michigan do not have authority to levy sales taxes; instead, the state collects sales tax, and distributes the revenue to local units in two portions. One is constitutionally dedicated to cities, villages, and townships (CVT) on a per capita basis, and the other is subject to annual appropriation. For the fiscal year 2019, 64 percent of payments to locals are constitutionally dedicated. Different formulas are used to distribute the revenues to CVTs and to counties. Table 1 summarizes the formulas, and this section describes the differences in detail.

**Table 1: Formulas of State Revenue Sharing for Counties and CVTs**

| | Constitutional SRS | Statutory SRS |
|---|---|---|
| **Cities, Villages, Townships** | 15 percent of sales tax at the rate of 4 percent. | "Percent payment" or "population payment" depending on FY 2010 statutory payment amount and CVT's population. |
| **Counties** | Not applicable | 25.06 percent of 21.3 percent of sales tax at the rate of 4 percent to be distributed on a per capita basis |

**Constitutional revenue sharing.**[14] According to the Michigan Constitution,[15] 15 percent of sales tax collections at the 4 percent rate[16] should be used exclusively for assistance to CVTs and distributed on a population basis. Counties do not receive constitutional revenue sharing payments.

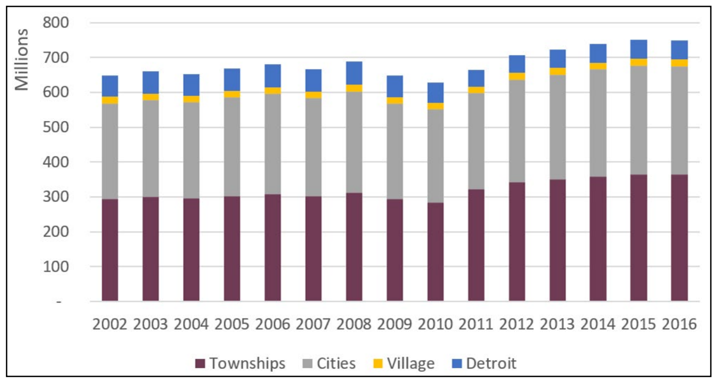
**Statutory revenue sharing.**[17] In addition to constitutional revenue sharing, CVTs also receive statutory revenue sharing subject to appropriation. Under PA 532 of 1998, full funding for statutory revenue sharing to CVTs should be 74.94 percent of 21.3 percent of sales tax revenue at the 4-percent rate. Unlike constitutional portion of the revenue sharing, the governor and Legislature have the ability to adjust the distributed amount of the statutory portion. Actual appropriations were routinely well below the full funding guideline. In fact, statutory revenue sharing payments only followed the provisions of PA 532 in fiscal year (FY)1999-00 and 2001-02. Between 2004 and 2011, reductions in funding and changes in the distribution formulas eliminated statutory revenue sharing payments for 1,033 CVTs. Only 740 CVTs received the payment in FY 2011, which was the last year in which statutory revenue sharing payments were made. (House Fiscal Agency 2017).

The Economic Vitality and Incentive Program (EVIP) replaced statutory revenue sharing in 2011, but it was never been codified into statute. A CVT would be eligible for EVIP payment if it fulfilled requirements related to accountability and transparency, consolidation and collaboration, employee compensation issues, and reducing unfunded liabilities. When EVIP was initiated, only 486 CVTs were eligible for EVIP funding (House Fiscal Agency 2017).

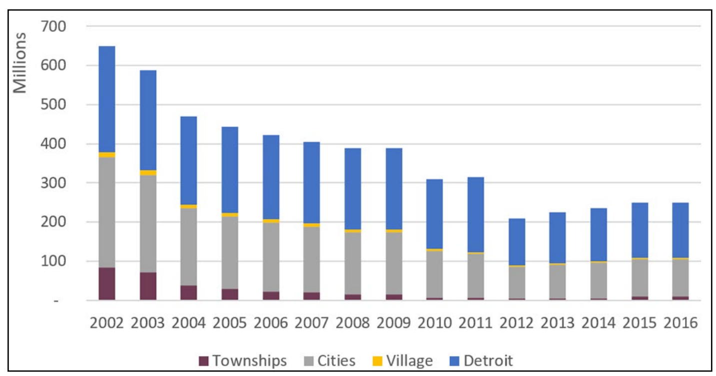
EVIP was short-lived; for FY 2014-15, all EVIP compliance requirements were eliminated except the accountability and transparency provision that requires CVTs to provide a citizen's guide to local finances that covers unfunded liabilities, a performance dashboard, a debt service report, and a biennial budget projection. Since 2014, total funding has remained at \$248.84 million. For FY 2017-18, an additional \$6.2 million was appropriated to eligible CVTs and distributed at \$0.81198 per person. An eligible CVT, if it had a FY 2010 statutory payment greater than \$4,500, would receive a "percent payment" equal to 78.51 percent of its FY 2010 statutory payment. If it had a population greater than 7,500, it would receive a "population payment" of \$2.65 a person. Eligible CVTs that meet both conditions would receive the greater of percent payment or population payment.

Compared to constitutional revenue sharing that remains relatively stable from 2002 to 2016 (figure 1), the statutory revenue sharing to CVTs (figure 2) shows more fluctuation. Cities and townships roughly receive the same amount of constitutional revenue sharing, whereas cities receive the majority of statutory revenue sharing, leaving little to townships. Also, note that because the formula for statutory revenue sharing relies on population, City of Detroit alone takes more than half of the amount.

#### Figure 2: Constitutional Revenue Sharing to Municipalities




#### Figure 3: Statutory Revenue Sharing to Municipalities




**County Incentive Program (CIP).** Counties receive revenue support from the state from another stream. Full funding for statutory revenue sharing to counties is 25.06 percent of 21.3 percent of sales tax revenue at the 4-percent rate (State Revenue Sharing Act of 1971, as amended by 1998 PA532). Statutory revenue sharing payments to counties were generally distributed on a per capita basis, although a portion was based on single business tax revenue that had been earmarked to counties as repayment for making inventories exempt from the personal property tax (House Fiscal Agency 2017).

As with CVTs, actual appropriations to counties were routinely below the full funding guideline. Statutory revenue sharing payments to counties were temporarily suspended beginning in FY 2004-05. Instead, counties were required to create reserve funds with own-source general operating revenue. When a county's reserve fund balance is exhausted, it will again be

14 Constitutional Revenue Sharing, Michigan Department of Treasury, at https://www.michigan.gov/treasury/0,4679,7-121-1751_2197_58826_62375---,00.html
15 Michigan Constitution of 1963, Article IX, Section 10, as amended.
16 The sales tax rate was increased to 6 percent in 1994. However, constitutional revenue sharing payments are still calculated based on the original 4 percent since the 2-percent increase is constitutionally dedicated to the School Aid Fund.
17 City, Village, and Township Revenue Sharing (CVTRS): County Incentive Program (CIP), Michigan Department of Treasury, *at* https://www.michigan.gov/treasury/0,4679,7-121-1751_2197_58826---,00.html.

eligible for statutory revenue sharing payments equal to its final authorized withdrawal amount (which is at the level of each county's FY2003-04 payment).

Beginning in FY 2013-14, 20 percent of a county's revenue sharing payment is subject to the County Incentive Program (CIP), which imposes the same transparency and accountability requirements as EVIP. In FY 2016-17 and FY 2017-18, an estimated 78 counties will receive statutory revenue sharing payments, leaving only five counties with positive reserve fund balances.

This last section highlights the key issues raised in this policy brief and some ideas or principles that can guide future policy reforms.

# Summary and Conclusion

## Regulatory Principles

Part of the state's role in local fiscal affairs is to establish a series of financial guardrails to ensure that all local governments remain solvent and at the same time can provide adequate local public services. These guardrails include: 1) debt limits and debt issuance rules, ) budgeting and accounting rules, 3) investment guidelines, 4) rules for fiscal distress management, 5) tax and revenue options, 6) labor and employment laws and others.

As these rules and potential changes are considered, a set of basic regulatory principles may be useful. The principles are prevention, partnerships, analytics and transparency. The **prevention** of local and school financial emergencies is far superior to the need for after the fact remediation. A **partnership** model that focuses on working and engaging with local governments and provides tools and resources that allow them to solve their own problems and challenges. Finally, **analytics and transparency** open local financial data to citizens and that uses best in class data to understand trends and patterns and move towards evidence-based decision making. A regulatory posture that promotes prevention as opposed to remediation requires a change in state statues as well as organizational structure.

Within this state created fiscal environment, Michigan local governments have significantly improved their financial bottom line. Fund balances are going up and the number of required deficit elimination plans has fallen significantly[18]. This recovery is a testament to prudent financial management and an improving state economy. That said, there are still a nontrivial number of local governments that remain at risk due to low fund balances stagnate local economic conditions and these state-imposed financial constraints[19]. Of equal importance, the constrained financial environment places many more locals at risk in the long-term as ongoing cost pressures continue to build.

Long term fiscal solvency remains a greater problem for many local governments, large and small. Deferred infrastructure investments and unfunded retirement liabilities are the biggest long term financial challenges facing local governments. These problems are magnified by broader socioeconomic changes in things like climate change and demographic shifts.

Fiscal solvency is an important matter. However, service solvency – the ability of local governments to provide critical public services at an adequate level to protect public health and safety - must also be considered. Recent research indicates that several dozen local governments are at immediate risk of being service insolvent.[20] This reality should be of equal concern as the risk of fiscal insolvency.

State government is the architect of the local government public finance system. Within this structure, local economic conditions and local management interact with state policy to determine the outcome of service and fiscal solvency. Today, we can say that local fiscal management is much improved and generally local economic conditions are better. Short term fiscal and service solvency are on an upward trajectory for many local governments. However, too many communities remain left behind and long term fiscal and service solvency for a large number of local governments remains a major risk. State-local fiscal policy requires additional tools in the short term for those communities left behind as well as for the long term fiscal and service solvency of the broader Michigan local government sector.

18 https://www.michigan.gov/documents/treasury/Fiscal_Health_of_Michigans_Local_Governments_2018_638566_7.pdf

19 Ibid 9

20 Robert Kleine and Mary Schulz, Service Solvency: An Analysis of the Ability of Michigan Cities to Provide an Adequate Level of Public Services, MSU Extension White Paper, Center for Local Government Finance and Policy, September 2017, at http://msue.anr.msu.edu/uploads/235/75790/GMI_062_Service_Solvency_Report-9-2017.pdf.

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