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# System Failure: Michigan's Broken Municipal Finance Model

## ***EXECUTIVE SUMMARY***



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# INTRODUCTION

This report, written by Plante and Moran, PLLC at the request of the Michigan Municipal League (MML), analyzes Michigan's municipal finance structure using specific data from a sample of Michigan local governments from across the State. This analysis is part of the MML's effort to demonstrate the structural financial problems facing local communities begun in March 2003, with the release of *Cities and Villages at the Crossroads: Fiscal Problems Facing Local Officials*, by Scott Schrager. This report goes into greater detail by calculating, for the first time, the actual impact of the interaction of the Headlee Amendment, Proposal A, and significant changes to the General Property Tax Act, on the financial condition of specific communities.

Property taxes are a critical revenue source for local governments. For fully developed communities, property taxes can represent fifty percent or more of a local government's General Fund budget. Over the last 26 years, there have been two constitutional amendments - the Headlee Amendment and Proposal A - and other related statutory changes that have impacted property tax revenue of local governments.

The Headlee Amendment, ratified in 1978, accomplished limiting the growth of property tax revenue by controlling how a local government's maximum authorized millage rate is calculated particularly as it relates to growth on existing property. The Headlee Amendment requires that when growth on existing property community wide is greater than inflation, the local government must "roll back" its maximum authorized millage rate so that the increase in property tax revenue caused by growth on existing property does not exceed inflation (commonly referred to as a "Headlee roll back").

In March 1994, Proposal A also created a new methodology to determine property values for tax purposes with the introduction of taxable value. Taxable value on each individual property cannot increase by more than the lesser of inflation or five percent annually until a property is sold or "transferred" regardless of how quickly existing property values may be growing. This difference between state equalized value and taxable value when a property is sold or transferred and before taxable value is reset to state equalized value is commonly referred to as the "uncapped value".

The remainder of this report analyzes the interaction of the Headlee Amendment and Proposal A 10 years after the passage of Proposal A. More importantly, the report also details several important changes made to the General Property Tax Act in 1994. **This report is not recommending changes to Proposal A.** The report intends to highlight the legislative changes made after Proposal A to the General Property Tax Act and their negative consequences on the finances of local governments.

# FINDINGS

1. With the passage of Proposal A in 1994, differences in taxable value and state equalized value were created due to the growth cap placed on taxable value (i.e. growth on taxable value of individual parcels limited to the lesser of inflation or 5%). In the first several years after Proposal A passed, the differences were not as pronounced as they are today. Now, as a result of the market value growth of real property in Michigan since 1994, the difference has become substantial.
2. When property is “transferred” (i.e., sold) as defined in State law, taxable value is reset again to equal state equalized value. This process of adjusting taxable value upward to state equalized value is commonly called “uncapping.” For the tax years 1999 through 2003, the survey shows that property transfers resulting in “uncapped values” (i.e. the difference between state equalized value and taxable value when property is transferred) are significant and consistent annually in each community.
3. On the surface, it may appear to the general public that a community with large amounts of “uncapped” property values annually would benefit financially from this addition of new property value to the tax base. However, although not taxed previously, these “uncapped values” were not included in the definition of exempt property for the purpose of Headlee roll back calculation when the legislature amended the General Property Tax Act in 1994. **The effect of this change to the General Property Tax Act has been to penalize communities that have had substantial market growth in existing property values by rolling back their millage rates.**
4. The survey results continue to indicate that there is downward pressure on millage rates. Survey participants reported declines in their Headlee maximum authorized millage from 1998 to 2003.
5. Even though “roll ups” of a local government’s maximum authorized millage rate (limited to the original authorized millage rate) were allowed following the Headlee Amendment in 1978, the implementing legislation after Proposal A eliminated Headlee roll ups. The Headlee maximum authorized millage rate for local governments continues to move farther away from the original authorized millage rate. The elimination of this self-correcting mechanism which allowed for roll-ups creates an almost permanent reduction of the millage authority of local governments.

## FINDINGS (continued)

6. The survey results demonstrate that the financial impact of the legislation changing the General Property Tax Act following Proposal A is punitive in nature. The combination of treating uncapped values as growth on existing property with limiting individual property taxable value growth to the rate of inflation produces a double reduction that was never intended by the voters on Proposal A in 1994.
7. More local governments will undoubtedly be forced by these legislative changes to seek Headlee override votes. Even for those local governments that are successful in achieving a Headlee override vote, the growing gap between taxable value and state equalized value will cause the roll back to repeat itself again without a change to the General Property Tax Act related to the treatment of “uncapped values”.
8. The data also shows that a greater burden has been placed on the residential tax base as noted below. The major developments that have occurred with business property taxes that explain this shift include: revisions to the general personal property tax tables by the State Tax Commission in the 2001 tax year; new personal property tax tables for the transmission and distribution property of utilities; the recent Michigan Supreme Court case, *WPW Acquisition Co v City of Troy*, creates an imbalance in the taxable values of certain real property assessed using the “occupancy” methodology. The combination of these changes has resulted in lower property tax values for business property.
9. The taxable value disparities that exist between neighbors (i.e. the person who has been in their home since Proposal A passed and the person who just bought their home right next door) have been well documented and publicized. This report demonstrates that many existing property owners who expected inflationary increases in their tax payments are annually receiving less than inflationary increases. Even though their taxable value is going up by the rate of inflation, property transfers are creating millage rate roll backs and reducing the millage rate levied. The net result? Less than inflationary increases in tax payments annually; not the represented intentions of Proposal A or Headlee.
10. This report quantifies the financial impact to each survey community of changing the treatment of “uncapped values” when property transfers and/or allowing Headlee roll ups. These changes are necessary to remove some of the stress from the municipal finance model and provide local governments with limited financial relief to deal with other financial challenges. These two corrections to the General Property Tax Act – exempting “uncapped values” created by property transfers from the Headlee roll back calculation AND allowing Headlee roll ups - will provide additional tax dollars that are within both the letter and the spirit of the Headlee Amendment and Proposal A. These two policy changes would provide local governments with additional millage capacity to use when needed with little impact on taxpayers.

## FINDINGS (continued)

11. Financial projections prepared by sample communities, using realistic revenue and controlled expenditure growth assumptions, disclose dangerous trends negatively impacting the financial condition of these local governments. It is important for local governments to maintain an adequate level of fund balance. Fund balance provides the necessary amount of working capital that a governmental unit requires to finance its day to day operations, meet payroll obligations and pay its bills timely given the borrowing limitations applicable to local governments.
12. The local governments participating in the survey reported the following:
  - ◆ Each of the local governments projected structural shortfalls for General Fund revenue and expenditures for the years 2004 through 2007.
  - ◆ Six of the eleven local governments that prepared projections for General Fund revenue and expenditures through 2007 report they will be in a General Fund fund deficit by 2007.
  - ◆ Absent changes to expenditures which will impact service levels, local governments plan to use critical amounts of General Fund fund balance between 2000 and 2007.
13. In addition to the corrections necessary to the General Property Tax Act, local governments face a variety of major financial challenges including other property tax matters (such as the utilities personal property tax case, the WPW decision, etc.). Cuts to state-shared revenue as shown by the chart below total over \$1 billion over a four year period beginning with the State's fiscal year 2001/2002. Although sales tax collections at the State continue to increase, the monies have not been returned to local governments as statutorily promised. While local governments supplement these revenue sources with fees and charges for services, there are limitations and restrictions on the amount of fees and charges that local governments can enact.
14. As a result of these uncoordinated State policy, legislative and judicial decisions, the municipal finance model is broken. Absent changes, local governments are on a financial collision course.