

**MICHIGAN SCHOOL FINANCE
UNDER PROPOSAL A**

**STATE CONTROL,
LOCAL CONSEQUENCES**

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EXECUTIVE SUMMARY

The changes produced by Proposal A have transformed Michigan's public school system. On balance, these changes have been decidedly positive. Proposal A led to a significant reduction in property taxes, while simultaneously reducing inequities in the resources provided for Michigan schools.

Proposal A also marks an unprecedented shift of power in Michigan's education system, from local communities to state officials. In the past, local citizens and educators played the leading role in decisions about school funding. Now the key actors are state legislators. Local authorities have lost the power to respond to local demands for more (or less) spending on schools. Instead they must look to Lansing.

The financial framework defined by Proposal A provides a sound basis for continued improvement in Michigan's education system, but this does not mean that our state's school finance policies cannot be improved. After 10 years, there are increasing strains in Michigan's school finance system, which should be addressed at the state level.

► **Proposal A has slowed the growth of total revenue available to Michigan's public schools.**

- After adjusting for inflation, statewide per pupil revenue increased by 13 percent between 1994 and 2002. Compared to the 1980-1994 period, the pace of annual real revenue growth since the passage of Proposal A has been cut by nearly half.
- The revenues earmarked for the School Aid Fund under Proposal A have never been adequate to satisfy the promises that the Legislature has made to Michigan's public schools. To make up the difference, the state has transferred an average of more than \$500 million per year from the state's General Fund to the SAF. The current structural deficit in the General Fund will make it extremely difficult for the Legislature to continue transfers at this level.

► **Proposal A has affected different school districts in different ways.**

The amount of money that the state allocates to each local school district depends on two main factors: the value of the district's per pupil foundation allowance, and the number of pupils enrolled in the district's schools.

- Most rural districts are better off under Proposal A, because their per pupil foundation allowance has increased dramatically. Some rural districts are worse off, however, because big enrollment declines have overwhelmed increases in the per pupil foundation allowance.
- Most suburban districts are also better off, because rapidly rising enrollment has compensated for relatively slow growth in the per pupil foundation allowance. In some lucky suburban districts the foundation allowance and enrollments have both increased significantly.
- Most central city and low-income suburban districts are worse off under Proposal A, because slow growth in the per pupil foundation allowance has been accompanied by falling enrollments.

- The real value of every district's foundation allowance has declined in each of the last two years. This trend will be difficult to halt in 2004-05.

► **Proposal A creates a mismatch between the revenues that the state provides to school districts and charter schools and the costs that they face.**

- Michigan's school funding system provides no compensation for regional cost of living differences, nor is state funding adequately adjusted to reflect differences in the cost of educating special needs students.
- Proposal A diminishes the services available to children in declining-enrollment districts, because revenues in these districts fall significantly more rapidly than costs.

POLICY RECOMMENDATIONS

Our recommendations are aimed at preserving the gains that have been accomplished under Proposal A, in the face of growing local pressure for change.

1. Avoid further declines in the real value of foundation allowances.

The Legislature should take steps to ensure the stability and adequacy of revenues earmarked for the School Aid Fund. The best way to do this would be for the state to increase the state education property tax, and to earmark these revenues for the SAF. This change could eliminate the need for annual General Fund transfers to the SAF, and make education funding less vulnerable to cyclical changes in Michigan's economy.

2. Fair and efficient funding should reflect differences in educational costs.

Schools facing higher costs must overcome an immediate disadvantage in their efforts to educate children to meet ambitious state performance standards. The Legislature should ensure that the basis for distributing revenues to schools and school districts reflects the actual cost of educating different students.

3. Students should not be harmed when other children leave their schools.

The precipitous revenue declines that now accompany falling enrollments are damaging the quality of education in many school districts. The financial burden that accompanies these declines must be distributed over a longer period, in order to give schools an opportunity to adjust to reduced revenues in a more deliberate and effective way. The Legislature has already modified Proposal A to provide small declining-enrollment rural districts with transitional support. This support should be extended to all declining-enrollment districts.

These proposals reinforce one another. Without additional revenues earmarked for the SAF, there is little chance of addressing declining enrollment and cost differentials in school funding. Similarly, unless the problems of declining enrollment and cost differentials are addressed, it is unlikely that additional SAF revenue will be allocated to the most pressing educational needs.

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I. INTRODUCTION

In March 1994 Michigan voters approved a dramatic change in the way our state funds its schools. Proposal A shifted the main source of education revenues from the local property tax to the state sales tax. The financing shift was accompanied by a shift in administrative and policy-making control to the state level. Decisions once made by local voters and local officials are now made by the Michigan Legislature. The changes produced by Proposal A have transformed Michigan's public school system.

In this report we review the changes that Proposal A has brought about in the level and distribution of educational revenues in Michigan, and we ask how these changes have affected local school districts. In the following chapter we review the political background to Proposal A, and explain how Proposal A works. We provide data on how the adoption of Proposal A has affected the revenues available to Michigan schools in the third chapter. The data confirm that school spending increased in Michigan in the years immediately following the adoption of Proposal A, and that Proposal A has made the distribution of revenues across Michigan school districts more equitable. Proposal A has not produced gains for all school districts, however. Some have experienced large revenue increases since 1994, but others have not. A growing number have experienced significant revenue losses.

Our analysis reveals two critical problems in the way Michigan now funds its schools, which we discuss in Chapter IV. First, Proposal A fails to ensure either fiscal stability or financial adequacy for Michigan schools. The revenue base for the state's School Aid Fund (SAF) is dangerously vulnerable to cyclical fluctuations in the economy. Revenue from sales and income taxes generally fall when the economy goes into recession. Because the SAF relies so heavily on sales and income taxes, economic downturns can lead to rapid declines in the revenues available for schools.

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In addition, the revenues earmarked for the SAF have never been adequate to satisfy the promises that the Legislature has made to Michigan’s public school system. The Legislature has supported growth in education spending by supplementing SAF revenues with annual appropriations from the General Fund and other sources. The “General Fund gap” in the SAF has averaged more than \$500 million per year since the adoption of Proposal A, even during the economic boom in the late 1990s. The emergence of a structural deficit in the General Fund and the exhaustion of one-time revenue sources means that future contributions to the SAF from general state revenues are doubtful at best. Michigan schools therefore face the prospect of significant and sustained funding reductions, even as their costs continue to grow.

The second critical problem is a potentially serious mismatch between the revenues that the state provides to school districts and charter schools¹ and the costs that they face. This problem has two key dimensions. On the one hand, Proposal A imposes a financial burden on districts where enrollment is declining, because their revenues fall significantly more rapidly than their costs. On the other hand, the foundation allowance that the state provides to school districts is not adjusted to reflect differences in the cost of educating different students, which diminishes the efficiency of Michigan’s emerging market for schooling. The failure to strike a better balance between revenues and costs poses an increasingly serious problem for many school districts and charter schools, including those facing the most severe challenges in Michigan’s education system.

The tenth anniversary of Proposal A’s passage is approaching, which presents a good opportunity to take stock of its impacts. In our view, Proposal A has accomplished the key goals that it was intended to address. It has produced substantial benefits for Michigan taxpayers, and it has promoted more uniform funding across local school districts. Reversing course on the key features of Proposal A would make many of the problems facing Michigan’s public school system worse, not better. We nevertheless argue that successfully addressing the critical problems identified above will require significant changes in the way Michigan funds its schools. In the fourth chapter of the report we propose strategies that would make Proposal A work better for all Michigan students.

¹ Charter schools are funded in the same way as traditional school districts under Proposal A. References to “school districts” in this report should be understood to apply equally to charter schools.

II. PROPOSAL A AND MICHIGAN SCHOOL FINANCE

Political Background to Proposal A

Before 1994, Michigan relied very heavily on local property taxes to fund schools. More than 60 percent of education revenues came from local sources, with the remainder provided by the state and federal governments. As a result, Michigan property taxes were among the highest in the nation.

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Reliance on local property taxes produced wide and growing inequities among Michigan school districts. Districts with lots of property wealth were able to provide lavish support for local schools while keeping property tax rates low. In contrast, property-poor school districts were obliged to tax themselves at higher rates to raise smaller amounts of revenue.

The property tax burden emerged as a major political issue in Michigan in the 1970s. The Milliken and Blanchard administrations developed a series of ballot initiatives aimed at changing the school finance system and reducing the property taxes paid by Michigan citizens. The voters defeated all of these initiatives at the polls. Between 1972 and 1990, Michigan voters rejected four different ballot proposals aimed at reducing property taxes.

Efforts to accomplish the same goal through legislation or litigation were equally unsuccessful.

When John Engler ran for Governor in 1990, one of his key campaign promises was a pledge to reduce property taxes by 20 percent. Following his election he put forward a new ballot initiative, which was opposed by the Michigan Education Association (MEA) and other education groups. The voters soundly defeated Proposal 1 in 1992. The following year the Governor developed a second initiative, in consultation with the MEA and other groups that had opposed his original plan. The voters rejected this second initiative as well.

Despite these defeats, political dissatisfaction with property taxes remained powerful, and the Governor remained committed to reducing them. In July 1993, during a Senate debate on the subject, Senator Debbie Stabenow challenged her Senate colleagues to simply eliminate local property taxes as a funding source for Michigan's public schools. Governor Engler urged support for Stabenow's proposal, which was quickly approved by both houses of the Michigan Legislature.

With this action, the Legislature eliminated Michigan's main source of educational revenue, leaving the state's public school system with a potential budget shortfall of almost \$6.5 billion. Members spent the following four months scrambling to develop a

plan to replace local property taxes as a funding source for public schools. They eventually came up with two options, a ballot initiative known as Proposal A and a “statutory alternative” that would be implemented automatically if the voters rejected Proposal A. The main revenue source identified in Proposal A was a 50 percent increase in the sales tax, while the “statutory alternative” relied mainly on an increase in the income tax. Both plans called for partial restoration of the property tax as a funding source for schools, with one portion to be levied by local districts and another by the state. In March 1994 Proposal A was overwhelmingly approved in a special election.

Policy Impact of Proposal A

Proposal A had three major impacts. First, it produced a large reduction in the property tax. According to the Michigan Department of Treasury, Michigan property taxes were 34.4 percent above the national average before the approval of Proposal A. After the implementation of Proposal A, Michigan property taxes were 14.8 percent below the national average. Between 1993 and 2002 the average millage rate on Michigan homes declined by 44 percent. The average homeowner in Michigan pays approximately \$2000 less in property taxes per year as a result of Proposal A.

Second, Proposal A produced a dramatic centralization of Michigan’s school finance system. Before the approval of Proposal A two-thirds of all education revenues were raised locally, and the voters in local school districts set their own property tax rates to support local schools. Since the approval of Proposal A, in contrast, the largest share of education revenues in Michigan has been raised and distributed by the state, and the rate of property tax that districts can collect to support local public schools is fixed by statute. As a result, local school districts have lost virtually all control over the amount of money available for the operation of their public schools.

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Third, Proposal A made school funding more equitable. In 1993-94, before the approval of Proposal A, per pupil spending in the highest-revenue school districts was more than three times higher than spending in the lowest-revenue districts. Since the implementation of Proposal A the spending gap has grown steadily smaller. Three-fourths of all school districts now receive the same per pupil foundation allowance, while the remaining districts receive somewhat more. The highest-revenue districts now spend about twice as much as the lowest-revenue districts. Proposal A reduced the gap by restraining revenue growth in Michigan’s highest-spending school districts and simultaneously providing significantly more revenue to low-spending districts.

How Does Proposal A Work?

To replace local property tax revenues, Proposal A increased the sales tax and a variety of other taxes, earmarking the new revenues for the School Aid Fund (SAF). The revenues

in the SAF are distributed to local school districts on a per-pupil basis. School districts receive a foundation allowance for each student they enroll.²

Revenues for the School Aid Fund

Table 1 displays the main sources of revenue for Michigan’s public school system, before and after the implementation of Proposal A. Sales and use taxes were increased from 4 percent to 6 percent, with all of the new revenues going to the SAF. Taxes on cigarettes and other tobacco products were significantly increased as well. A real estate transfer tax of 0.75 percent was introduced. All of the new revenues from these taxes were earmarked for the SAF. In addition, 14.4 percent of revenues from the income tax (subsequently increased to 23 percent) were also earmarked for the SAF.

Table 1

SAF Revenue Sources, Before and After Approval of Proposal A

<u>Revenue Source</u>	<u>Prior to Reform</u>	<u>Proposal A</u>
Sales Tax	60% of proceeds from the 4% rate	60% from the 4% rate and 100% from the 2 percentage point increase
Use Tax		All revenue from the 2 percentage point increase
Income Tax		14.4% of collections from the 4.4% rate (down from 4.6%)
Real Estate Transfer Tax		All revenue from the .75% tax
Cigarette Tax (per pack)	\$.02 of the \$.25 tax	63.4% of proceeds from the \$.75 tax
Other Tobacco Products		Proceeds of the 16% tax (on wholesale price)
Liquor Excise Tax	Revenue from the 4% tax	Revenue from the 4% tax
Lottery	Net revenue	Net revenue
State Tax on all Property		6 mills
Local Homestead Property Tax	34 mills (average)	0
Local Non-homestead Property Tax	34 mills (average)	18 mills

Source: Michigan House and Senate Fiscal Agencies, “The Michigan School Aid Act Compiled and Appendices.” Appendix A, October, 1994.

² The foundation allowance is supplemented in most districts by state and federal “categorical” funding for specific purposes including special education.

Property taxes have continued to provide a significant share of educational revenues since 1994. The state levies a uniform 6 mills on all property, with the revenue going directly to the SAF. Local school districts are required to levy an additional 18 mills on non-homestead property, with voter approval.³ Revenues from the tax on non-homestead property remain at the local level. These revenues represent local districts' contribution to the state's foundation allowances. All of the non-homestead revenues that districts raise locally are completely offset by corresponding reductions in state aid within the state funding formula. As a result, property taxes to support schools are effectively state rather than local taxes.

Proposal A permits a small set of districts that had very high spending levels in 1994 to levy additional property taxes on homestead property, subject to the approval of local voters.⁴ About seven percent of the districts in the state are in this "hold harmless" group. Some of these districts, including several in suburban Detroit, are very wealthy. Others are home to large concentrations of valuable non-homestead property, ranging from vacation homes to shopping malls to nuclear power plants. The revenue from local millages allows these districts to maintain their spending at pre-Proposal A levels, but it does not permit them to increase their spending further. Like all other school districts, the "hold harmless" districts can only increase their revenue each year by the amount of the annual increase in the statewide basic foundation grant.

In the first three years after the implementation of Proposal A, local school districts were permitted to seek enhancement millages of up to three mills from local voters. The revenues from these millages could be used to supplement the funding provided by the state. Since 1997, however, local school districts may no longer seek enhancement millages unless they act in concert with the other districts in their Intermediate School District (ISD). ISD enhancement millages must be approved by a majority of the electors in the ISD, and the revenues must be shared across districts on an equal per-pupil basis. Only one ISD has won approval for an enhancement millage since 1997.

The General Fund Gap

When Proposal A was first approved, the Legislature's original intention was that annual increases in the foundation allowance would be strictly determined by the increase in revenues into the SAF, adjusted for changes in enrollment.⁵ In fact, however, the revenues earmarked for the SAF under Proposal A fell short of the funds needed to meet Legislative commitments to Michigan's public schools from the start. The difference between the amounts promised to schools by the Legislature and the funds available in

³ In Michigan, "homestead" property is limited to owner-occupied primary residences. All other property, including rental property and vacation homes, is "non-homestead" property.

⁴ Without these local millages, maintaining pre-1994 spending levels in these districts would have placed too great a strain on the SAF.

⁵ For further discussion see C. Philip C. Kearney and Michael F. Addonizio, [A Primer on Michigan School Finance](#), Fourth Edition, 2002, pp. 23, 30.

the SAF has been made up each year with revenues from the state's General Fund budget. (See Table 2.) Nothing in Proposal A requires General Fund contributions to the SAF. These discretionary transfers depend on specific appropriations by the Legislature. Between 1995 and 2003 these supplemental appropriations amounted to roughly \$5 billion, or about 6 percent of all SAF revenues.

In fiscal years 1995 and 1996 more than \$600 million in General Fund revenues were allocated to the SAF. In fiscal year 2002 the Legislature also contributed approximately \$600 million to the SAF, drawing \$200 million from the General Fund budget, along with almost \$400 million from the Budget Stabilization Fund (the "rainy day" fund). On average, the Legislature has transferred approximately \$560 million to the SAF every year since Proposal A was approved.

Michigan's current budgetary problems can be attributed in part to recession, but it is now becoming apparent that the state's General Fund faces a long-term, structural mismatch between spending obligations and revenues. The structural deficit in the General Fund will persist even after a rebound in economic activity.⁶ In recent years the state has made substantial (and continuing) cuts in the single business tax and the income tax. The foregone revenue from these tax reductions amounts to about 14 percent of the General Fund's revenue. Despite substantial spending cuts already implemented, a \$600 million General Fund deficit is now projected for fiscal year 2004. The projected deficit for fiscal year 2005 is \$1.2 billion. To balance the budget, either taxes must be increased or spending obligations must be further reduced, which raises the question whether the Legislature can or will continue to fill the "gap" in SAF revenues.

Table 2
The General Fund "Gap" in Michigan's School Aid Fund, 1995-2002

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
General Fund transfer	665	621	278	376	421	420	385	198
Other transfers (BSF)	8	180	23	212	112	48	149	382
School Aid Fund	7,738	8,264	8,691	9,469	9,950	10,479	10,677	10,949
General Fund "gap" (\$)	673	801	301	588	533	468	534	580
General Fund "gap" as percentage of SAF	8.7	9.7	3.5	6.2	5.4	4.5	5.0	5.3

Source: Michigan Department of Treasury (2002)

⁶ Citizens Research Council, "A Recap of the FY2004 Budget and a Look Ahead to FY2005 and Beyond," October 2003. Available at www.crcmich.org.

Distribution of Revenues to Individual Districts

The initial foundation allowance that each school district received in 1994-95 was based on the revenues that the district had received from state and local sources in 1993-94. High-revenue school districts were “held harmless” by ensuring that they continued to receive at least the same amount of revenue as they had received under the previous school finance system.⁷ Under Proposal A, these districts received significantly more money from the state than other districts, but their revenues increased at a much slower rate.

The agreement to “hold harmless” previously high-spending school districts had two main consequences. First, it meant that increased equalization had to be accomplished by “leveling up” (increasing the revenues provided to low-spending districts), rather than by “leveling down” (decreasing the revenues provided to high-spending districts). Second, since the total tax revenue earmarked for education under Proposal A fell far short of the amount needed to raise all districts up to the revenue levels of the highest spending districts, the value of the foundation allowance would continue to vary widely across Michigan school districts.

In the seven years following the adoption of Proposal A, each Michigan school district was assigned to one of three groups, based on their previous levels of education revenues. Per pupil foundation allowances increased in all districts, but the lowest-revenue districts received significantly larger increases than higher-revenue districts. In general, funding increased most dramatically in small, rural districts. In Onaway, for example, the per

Funding differentials between the lowest and highest revenue districts will...persist indefinitely in the absence of further legislative action to reduce them.

pupil foundation allowance nearly doubled under Proposal A, from \$3,398 in 1994 to \$6,700 in 2003. In urban and suburban districts, in contrast, funding increases were generally smaller. In Flint, for example, the per pupil foundation allowance increased by about 30 percent, from \$5,555 in 1994 to \$7,252 in 2003. In Bloomfield Hills, the foundation allowance increased by about 16 percent, from \$10,294 in 1994 to \$11,954 in 2003. By providing larger increases to previously low-spending districts, Proposal A reduced inequities in funding across districts.

Since 2001 all school districts have received the same annual increase in their per pupil foundation allowance. The remaining funding differentials between the lowest and highest revenue districts will

⁷ In fact, high-revenue districts received a funding increase of at least \$160 per pupil in the first year of implementation.

therefore persist indefinitely in the absence of further legislative action to reduce them.⁸

Proposal A distributes foundation revenues to school districts based on the number of students that they enroll. The amount of money that the state allocates to each local school district therefore depends on two main factors: the value of the district's per pupil foundation allowance, and the number of pupils enrolled in the district's schools. The revenues available to the school district grow when the value of the per pupil foundation allowance rises, or when enrollment increases. School districts must make do with fewer resources when the value of the per pupil foundation allowance falls, or when enrollment declines.

Since the adoption of Proposal A in 1994, the per pupil foundation allowance has increased nearly every year, for every Michigan school district.⁹ As noted above, the foundation allowance has increased more rapidly in some districts than in others, but the allowance has increased in all districts.¹⁰ In contrast, enrollments have increased in some school districts, and fallen in others. At the district level, therefore, the fiscal impact of Proposal A depends at least as much (and often more) on changes in enrollment as it does on changes in per pupil funding.

In the following chapter we present data that address two questions. First, we explain how overall financial support for Michigan public schools has changed under Proposal A. There is no doubt that total funding for schools has increased substantially since 1994. The real questions are whether Proposal A slowed or accelerated real revenue growth, and whether the trajectory of funding growth can be maintained. We also place the state's financial commitment to schools in historical and comparative perspective, by documenting rates of growth in Michigan's educational revenues in the years before and after the approval of Proposal A, and by comparing education funding in Michigan to funding in other states.

Second, we show how Proposal A has changed the distribution of revenue among local districts. The new revenues dedicated to education under Proposal A have changed the size of the financial pie available to public schools, but Proposal A has simultaneously changed the way the pie is sliced. Many districts are better off than they were before the approval of Proposal A. Others are worse off, however, and the number of "losers" is growing.

⁸ All districts receive the same dollar increase each year. For example, the value of the foundation allowance increased by \$200 between 2001 and 2002. This uniform per pupil increase represents a smaller percentage growth in revenue for high-spending districts than lower-spending districts.

⁹ There was no increase in districts' foundation allowances in 1998-99. In addition, the state implemented a pro-rata reduction in the foundation allowance in FY2003, and an additional reduction for FY 2004 is very likely despite good intentions in both the Legislative and Executive branches.

¹⁰ In some of Michigan's wealthiest school districts the increase in the foundation allowance has not kept pace with inflation. These districts have experienced reductions in the real value (or purchasing power) of their foundation allowances, even though the nominal value of the allowance has increased.

III. MEASURING THE IMPACT OF PROPOSAL A

Trends in Total Financial Support for Michigan Public Schools

How has overall financial support for Michigan public schools changed under Proposal A? Have education revenues increased more or less rapidly under Proposal A than under Michigan's previous system of school finance? How sound are the future financial prospects for Michigan schools under Proposal A? Answers to these questions are essential to an evaluation of the adequacy of Michigan's new school finance system.

Table 3 displays changes in the level of combined state and local operating revenue for public schools in selected years over the past two decades.¹¹ To make valid comparisons over time, it is necessary to account for a change in funding responsibility for the state's school employee retirement system. Before Proposal A, the state paid the employers' contribution to the Michigan Public School Employee Retirement System (MPERS). This responsibility was shifted to local districts when Proposal A was implemented. As a result, the revenue data for 1994 and prior years in Table 3 do not include the employers' MPERS contribution, but the 2002 data do. In order to generate post-Proposal A revenue figures that are strictly comparable to the pre-Proposal A period, Table 3 also displays 2002 revenue figures that exclude the employers' MPERS contribution.

¹¹ Unless otherwise noted, all the data in this report refer to school years. For ease of exposition, however, we refer to school years by the corresponding fiscal year. So, for example, 1994 refers to the 1993-94 school year, the last school year before Proposal A took effect. Data on most components of district-level finances are now available only through 2002.

Table 3**Total State and Local Operating Revenue for Michigan Schools**

<u>Year</u>	<i>(millions)</i>			<i>(per pupil)</i>	
	<u>Current Dollars</u>	<u>2002 Dollars</u>	<u>Statewide Membership</u>	<u>Current Dollars</u>	<u>2002 Dollars</u>
1980	3,651	7,970	1,910,385	1,911	4,172
1987	5,497	8,708	1,657,423	3,317	5,254
1994	8,482	10,297	1,667,041	5,088	6,177
2002	13,083	13,084	1,731,092	7,558	7,558
2002*	12,082	12,082	1,731,092	6,980	6,980
			<u>Growth Rates</u>		
1980-87	5.8	1.3	-2.0	7.9	3.3
1987-94	6.2	2.4	0.1	6.1	2.3
1994-2002	5.4	3.0	0.5	4.9	2.5
1994-2002*	4.4	2.0	0.5	3.9	1.5

Notes: Figures are based on total general fund revenue of all local and intermediate school districts and charter schools. * Excludes employers' contribution to the Michigan Public Schools Employees Retirement System.

The total revenues available for the operation of Michigan's public schools have increased since 1994. In current dollars, school revenues in 2002 were \$13.1 billion, an increase of \$4.6 billion over 1994. Adjusting for inflation and the change in MPSERS financing responsibility, total education revenues in 2002 still exceeded those in 1994 by about \$2 billion. This represents an increase of 13 percent, or \$803, in average real per pupil revenues between 1994 and 2002.

The bottom panel of Table 3 displays changes in the pace of revenue growth over three periods, two periods before the passage of Proposal A and one afterwards. Between 1980 and 1987, total real revenues per pupil increased at a fairly rapid annual rate of 3.3 percent. This rate of increase resulted from modest growth in real revenues coupled with declining statewide enrollment. Per pupil revenue growth slowed in the 1987-1994 period, despite an acceleration in total revenue, because the state's enrollment began to increase again.

Table 3 shows that the growth of real per pupil revenues slowed further after the passage of Proposal A. Total revenues and enrollment both increased after 1994, but part of the revenue growth reflects the change in funding responsibility for MPSERS. After adjusting for this shift, it is clear that the growth of both total and per pupil real revenue

for Michigan school districts has slowed since the passage of Proposal A. The annual growth of real per pupil revenue between 1994 and 2002 was 1.5 percent, the slowest growth over any period during the last two decades. Revenue growth under Proposal A nevertheless outpaced inflation between 1994 and 2002.

In order to increase school funding even at this slower pace, Michigan has been obliged to allocate a growing share of total government spending to elementary and secondary education. Table 4 displays the share of all state and local government expenditures devoted to education in selected states. Compared to the nation as a whole, Michigan devotes a relatively large share of its government spending to education. Moreover, this share increased significantly after the implementation of Proposal A, from 26 percent in 1994 to 29 percent in 1999 (the most recent year for which U.S. Census data are available.)

Table 4
State Plus Local K-12 Education Expenditures
as a Percentage of Total Government Expenditures

	<u>1994</u>	<u>1999</u>	<u>Change</u> <u>1994 to 1999</u>
Michigan	25.84	28.55	2.71
Wisconsin	25.40	26.98	1.58
Indiana	25.26	26.11	0.85
Illinois	22.81	25.80	2.99
Ohio	24.43	25.50	1.07
New York	21.63	22.95	1.32
California	19.47	21.48	2.01
United States	23.00	24.30	1.30

In summary, Michigan now funds its schools at a higher level than before Proposal A, but the rate of annual growth in financial support has slowed in the years between 1994 and 2002 when compared with earlier periods. As we discuss below, the recent decline in state revenues has reduced the rate of growth even further since 2002.

The Current Budget Crisis

Like several other states, Michigan is facing one of its worst budget crises since World War II. In fiscal year 2003, a revenue shortfall in the SAF produced the first reductions in foundation support for Michigan school districts since Proposal A was approved in 1994. To restore those cuts and preserve the basic foundation allowance for another year

at \$6700, the Legislature cut over \$140 million in categorical programs (adult education, career preparation, gifted and talented) from the 2004 budget.

As it turns out, however, the 2003 budget was overly optimistic. SAF revenue collections fell short of projections by nearly \$100 million. The 2004 budget must therefore be reassessed to take account of a smaller revenue base and a slower rate of growth in the SAF than legislators had previously assumed. By all accounts, it will be a challenge to avoid cuts in the \$6700 basic foundation allowance during 2004. Current revenue projections suggest the possibility of further cuts in real terms during fiscal year 2005.

Education revenues in Michigan are no longer keeping pace with the rising operating costs that schools face.

Education revenues in Michigan are no longer keeping pace with the rising operating costs that schools face, and school districts across the state are cutting programs and services in response. The squeeze is most acute in districts where enrollment is declining. What accounts for this shift? Is it merely the transitory fallout of an economic recession? Or does it point to structural flaws in the state's system of school finance under Proposal A?

Without doubt there is a strong cyclical component to the present fiscal predicament of Michigan's schools. Both sales and income taxes are sensitive to business cycle fluctuations. Together, these two taxes account for two-thirds of the SAF's tax revenue. It is no surprise that collections from sales and income taxes weakened during the recession. What might seem odd, however, is that according to the National Bureau of Economic Research the national recession started in March 2001 and officially ended in November 2001. Why did it take until 2003 for the budget crunch to hit Michigan schools?

The answer to this question has two key elements. First, revenues from the state education property tax held up very well during the recession. Total tax revenues flowing to the SAF *increased* modestly in fiscal years 2001 and 2002, because property tax collections grew robustly in both years, by about 8 percent in 2001 and 6 percent in 2002. The property tax accounts for only about 14 percent of the SAF's tax revenue, but growth in property tax receipts accounted for 80 percent of the increase in tax revenue during the recession.¹²

Second, and more importantly, between 2001 and 2003 the Legislature sought to compensate for sagging SAF tax collections by transferring nearly \$2 billion to the SAF from a variety of one-time sources. The surpluses that had built up in the SAF and Budget Stabilization Fund were entirely depleted. School bonds were refinanced to take advantage of lower interest rates. A portion of the financial assistance provided to

¹² In addition to being a more stable revenue source, the state education property tax has also displayed a faster long-term growth trajectory (or income elasticity). Even before the recession, the growth rate of state property tax collections exceeded sales tax collections by nearly 50 percent between 1995 and 2000, despite provisions in Proposal A that fix the tax rate at 6 mills and restrict increases in the taxable value of individual properties to the lesser of 5 percent or the rate of inflation. Faster growth in overall property tax collections is spurred by the expansion of assessment rolls due to new construction and the reassessment of properties at resale.

Michigan by the federal government was shifted to the SAF. For fiscal year 2003, the summer property tax collection was accelerated, so in effect there were three tax collections during the year instead of two. The problem now facing the Legislature is that these one-time revenue sources have been exhausted, and are no longer available. In fiscal years 2004 and after the SAF will have to rely on tax revenue growth to replace these funds, and state tax collections have yet to rebound.¹³

The challenge confronting the 2004 and subsequent budgets is readily illustrated. In drawing up the budget for fiscal year 2004, the Legislature estimated that SAF tax revenues would increase at a rate slightly over four percent. A four percent growth in SAF tax revenues would generate about \$400 million in additional funds. This amount would almost replace the special one-time revenue supplements used up in the 2003 budget. It would not produce any increase in the SAF's total revenues. If SAF tax revenues increase by less than four percent—as now seems probable—total SAF revenues in 2004 will fall below the levels of 2003.

Even if the Legislature manages to maintain total SAF revenues at the 2003 level, cutbacks will have to be made in school programs. The basic foundation allowance (\$6700) must increase by about \$150 at the current rate of inflation (2.2 percent) to maintain its purchasing power. Protecting the basic foundation allowance against inflation would require an aggregate increase of about \$260 million in the SAF in 2004 as compared to 2003. Even at this level of funding, however, high-revenue districts would still have to make cuts. A foundation increase of \$150 for a district with a \$12000 foundation allowance represents only a 1.25 percent funding increase, well below the rate of inflation. In addition, a few key costs that school districts face are increasing faster than the rate of inflation, including expenses for employee health care and pensions. According to the Citizens Research Council, it is entirely possible that any increase in foundation support that the state might manage in the next couple years will be completely absorbed by mandatory increases in districts' employee retirement contributions.

The current budget crisis brings the vulnerabilities of Michigan's school funding under Proposal A into sharp focus.

As the economy rebounds and income and sales tax revenues revive, the fiscal integrity of the SAF will improve. As noted above, however, this will not solve the financial problems facing Michigan schools, because of the persistent General Fund gap in SAF revenues. Transfers from the General Fund accounted for 40 percent of the increase in real per pupil education revenues that occurred between 1994 and 2002, averaging more than \$500 million each year. The General Fund now faces a large deficit, however, because projected revenues are no longer sufficient to meet current spending commitments. The deficit in the General Fund is structural, not cyclical—it will not go away even if the economy recovers. As a result, transfers to the SAF on the scale of recent years cannot be sustained without major cuts in other areas of the

¹³ Both sales and income tax collections declined during the fourth quarter of fiscal year 2003, fully two years after the recession's trough.

state budget.

The current budget crisis brings the vulnerabilities of Michigan's school funding under Proposal A into sharp focus. The extent to which it will alter the long term trajectory of revenue growth for Michigan schools is not yet clear, but there are few grounds for optimism. If SAF revenues remain flat through fiscal year 2005, as now appears plausible, and current rates of inflation and enrollment growth remain unchanged, then the annual rate of real per pupil revenue growth for Michigan schools since 1994 will have declined to 0.3 percent. We return to this issue in Section IV, in our discussion of current school finance policy issues.

Changes in the Distribution of Revenues among Local Districts

One of the key goals of Proposal A was to narrow the gap between high- and low-revenue school districts in Michigan. The finance reform did in fact bring about substantial progress on this front. Formerly low-spending districts received the largest revenue increases, while revenue growth in high-spending districts was constrained. Proposal A also reduced, but did not eliminate, the very close association between districts' revenues and their local property wealth that characterized school funding in Michigan before 1994.

Table 5 documents the decline in fiscal disparities among Michigan districts. For this analysis we grouped school districts by the level of their foundation allowance in 1994. We then examined increases in foundation allowances for each group between 1994 and 2002. In the lowest-revenue group the average foundation allowance increased by \$2,474. In the highest-revenue group the average increase was only \$1,395. In real dollars, the lowest-revenue districts received an additional \$1,616 per pupil, while revenues in the highest-spending districts failed to keep pace with inflation.

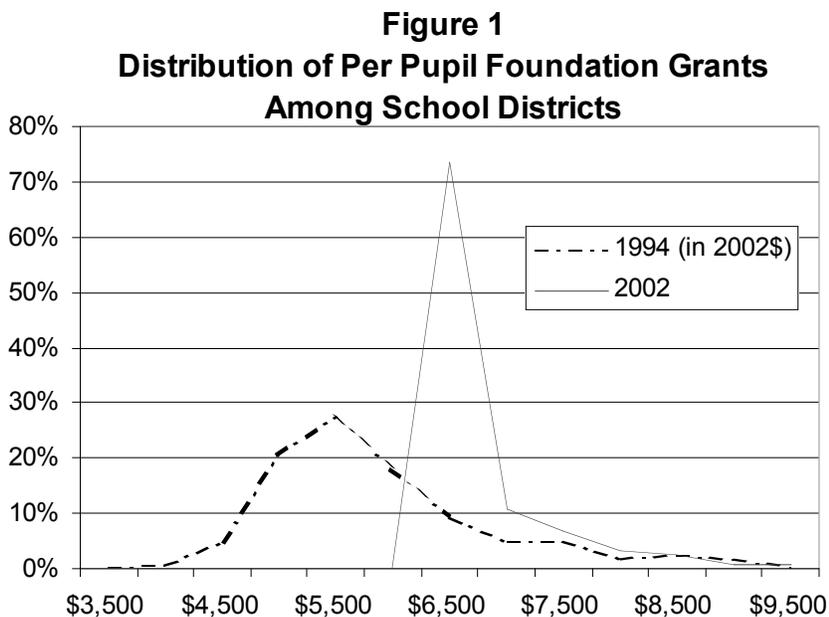
Table 5

Change in Foundation Allowance by 1994 Foundation Quintiles

Quintile	Mean foundation allowance			Difference	
	<u>1994</u>	<u>1994 in 2002 \$</u>	<u>2002</u>	<u>Current dollars</u>	<u>2002 dollars</u>
1	\$4,026	\$4,884	\$6,500	\$2,474	\$1,616
2	4,385	5,320	6,500	2,115	1,180
3	4,672	5,669	6,500	1,828	831
4	5,242	6,360	6,766	1,524	406
5	6,593	7,999	7,988	1,395	-11

Note: Each quintile includes 111 school districts.

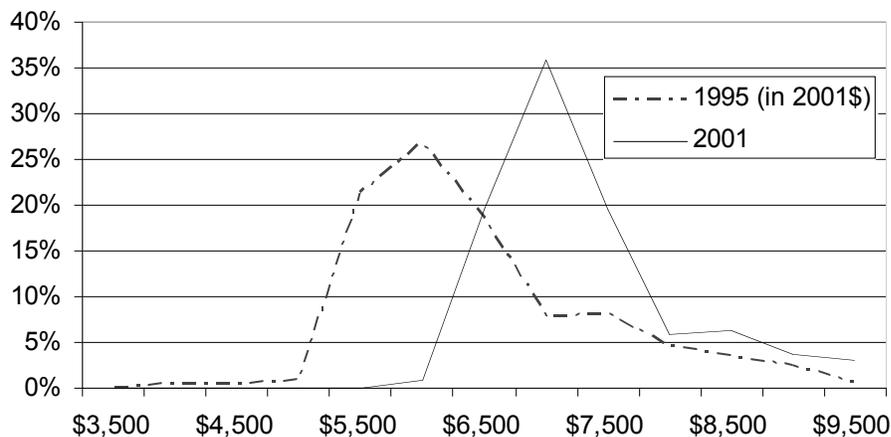
The equalization of per pupil foundation allowances across districts is portrayed in Figure 1. The figure clearly shows that Proposal A increased equalization by “leveling up” low-revenue districts. By 2002, three-fourths of Michigan school districts received the same per pupil foundation allowance of \$6,700 from the state.



Note: To accommodate scaling, a few very high-revenue districts have been omitted from Figures 1 and 2.

The per pupil foundation allowance that school districts receive from the state accounts for 85 percent of all operating revenue among Michigan school districts. Federal revenues account for another 5 percent, and state categorical grants and local fees account for the remaining 10 percent. Figure 2 adds revenues from these other sources to foundation revenue. The figure shows that inter-district disparities in total per pupil revenues have narrowed since the approval of Proposal A, but by somewhat less than the disparities in foundation revenue alone.

Figure 2
Distribution of Per Pupil General Fund Revenue
Among School Districts



The improvement in fiscal equity that has taken place in Michigan under Proposal A compares very favorably to recent trends in other states. Table 6 depicts the extent of funding variation among local school districts in several states. Under Proposal A, Michigan has gone from having greater funding inequality than the median state to being more equal than the median state. In 1994, 32 states had more equal distributions of per pupil revenues across districts than Michigan. By 2000, only 17 states had a more equal distribution.

The pace at which Michigan reduced funding disparities between 1994 and 2000 was especially dramatic. Only four states (Nevada, Texas, Washington, and Wyoming) accomplished larger reductions in revenue inequalities during this period. Michigan has continued to improve school revenue equity in the years since 2000.

Table 6

Inequity of Per Pupil Revenue among Districts in Selected States

	Coefficient of Variation		Change
	<u>1994</u>	<u>2000</u>	<u>1994 to 2000</u>
Nebraska	.46	.73	.27
New York	.38	.43	.05
Ohio	.30	.40	.10
Illinois	.38	.29	-.09
Colorado (median state)	.26	.28	.02
Michigan	.32	.20	-.12
Wisconsin	.15	.12	-.03
Indiana	.14	.12	-.02
Hawaii	0.0	0.0	0

Note: The coefficient of variation is obtained by dividing the standard deviation by the mean. These figures are based on total state plus local general fund revenue per pupil in individual school districts in each state. Smaller coefficient values imply less inequality.

Changes in Foundation Allowances by Local Community Characteristics

Michigan citizens often suppose that Proposal A has shifted school revenues from communities inhabited by rich households to those inhabited by poor households. This would necessarily be true only if district median family income and school revenues in 1994 had been perfectly correlated. In fact, however, the correlation between family income and school revenue in 1994 was positive, but not perfect. Many middle income communities had low per pupil revenues in 1994 because they chose to tax themselves at low rates. By the same token, many communities with high concentrations of poor households, including most of Michigan's central cities, had per pupil revenues at or above the statewide average in 1994. Per pupil revenue was relatively high in these communities because of the presence of substantial non-residential property, relatively high local tax effort (millage rates), and the distribution of state aid before Proposal A.

Table 7 shows the relationship between foundation allowance increases under Proposal A and community income levels. We grouped the state's 555 school districts into quintiles based on their 1990 median family income. The highest income districts have indeed received the smallest foundation increases. The state's lowest income districts, however, have not gained the most. The average foundation allowance increase was greater for

districts falling between the 20th and 80th percentiles of family income distribution than for the state's poorest quintile of districts.

Table 7

**Change in Foundation Allowance
by District Median Family Income Quintiles**

Mean district foundation				
Quintile	1994	1994 in 2002\$	2002	Difference 2002 dollars
1	\$5,114	\$6,205	\$6,809	\$604
2	4,725	5,733	6,628	895
3	4,804	5,828	6,689	861
4	5,101	6,188	6,827	639
5	5,904	7,164	7,400	236

Note: 1 is the lowest-income quintile, and 5 is the highest-income quintile.

The formulas that determine district foundation allowance increases under Proposal A take no account of community racial or ethnic characteristics. Districts with differing racial compositions have nevertheless fared differently under the finance reform. In Table 8 we grouped Michigan's school districts by the percentage of their students who were African-American in 1994. African-American students are very unevenly distributed across the state's school districts. Although they make up 19 percent of students statewide, African-Americans comprise less than one percent of the students in nearly 70 percent of Michigan's school districts. African-American students represent more than a third of the students in only 25 districts, fewer than five percent of the school districts in Michigan.

Table 8

**Change in Foundation Allowance
by District Racial Composition**

Percent African-American enrollment (1994)	Number of districts	Mean foundation (2002 \$)		Difference
		1994	2002	
0 – 1 %	381	\$5,849	\$6,776	\$927
1 – 5	110	6,430	7,032	601
5 – 33	39	6,205	6,879	674
>33	25	7,050	7,292	242

The foundation increase for the group of districts with the highest concentration of African-American students is smaller than the increase received by the state's richest quintile of districts.

The results of this analysis are striking. The districts with the highest share of African-American students have had the smallest foundation allowance increases since 1994. Indeed, the foundation increase for the group of districts with the highest concentration of African-American students is **smaller** than the increase received by the state's richest quintile of districts measured by family income. (See Table 7.) The average real foundation increase in districts where African-Americans comprise less than one percent of enrollment is nearly four times the increase in districts where at least one-third of the students are African-American.

For the state as a whole, the average real increase in the foundation grant received by African-American students between 1994 and 2001 was \$208 (in 2001 dollars). The average real foundation grant increase for all non-African-American students was \$338, which is more than 60 percent higher.

Changes in Total Foundation Revenue by Community Characteristics

Under Proposal A the state distributes revenues to school districts on a per pupil basis. The financial prospects of districts under Proposal A therefore depend on the interaction of two variables: (1) changes in the per pupil foundation allowance, as discussed above and (2) changes in enrollment. Discussions of the impact of Proposal A have generally focused on changes in the value of foundation allowances, but enrollment changes have had equally large effects on district revenues.

Table 9 shows how the interaction of these two variables has affected total foundation revenue in some illustrative Michigan school districts. (All dollar figures in Table 9 are in real, or inflation-adjusted, terms.) The first group in Table 9 includes districts where both variables are increasing. In these lucky districts the real foundation allowance received from the state has increased rapidly, and enrollments have increased as well. In rapidly developing districts on the outskirts of metropolitan areas—places like Pinckney, Hudsonville, and Rockford—total revenues available for local schools have grown dramatically since the adoption of Proposal A.

The second group in Table 9 includes districts where declining real foundation allowances have been compensated by very rapid enrollment growth. In metro Detroit, for example, suburban school districts including Lake Orion, Dearborn, Northville and West Bloomfield have enjoyed large increases in total revenue without increases in their real foundation allowance, because enrollments have increased steadily. The same is true for some suburban districts in west Michigan, including Forest Hills in Kent County.

Table 9

Real Foundation Revenue Growth for Selected Districts, 1994 – 2001

District	% Change in real foundation allowance	% Change in enrollment	% Change in total real foundation revenue
<i>1. Increasing real foundation allowance, increasing enrollment</i>			
Hudsonville	29.2	33.5	72.5
Vandercook Lake	13.2	34.8	52.6
Pinckney	14.0	27.2	45.1
Rockford	14.0	24.8	42.3
Howell	5.1	27.5	34.0
<i>2. Declining real foundation allowance, increasing enrollment</i>			
Lake Orion	-0.1	42.1	42.0
Forest Hills	-0.7	30.6	29.7
Northville	-4.4	33.3	27.4
Dearborn	-5.3	27.9	21.1
W. Bloomfield	-5.6	22.2	15.4
<i>3. Increasing real foundation allowance, declining enrollment</i>			
Escanaba	11.1	-14.6	-5.2
Hillsdale	20.3	-26.5	-11.6
Ishpeming	20.6	-28.6	-13.8
Benton Harbor	15.0	-28.9	-18.3
Gwinn	32.7	-50.8	-34.7
<i>4. Slow increase in real foundation allowance, declining enrollment</i>			
Detroit	2.4	-10.1	-7.9
Flint	1.7	-16.9	-15.4
Lansing	2.3	-18.6	-16.7
Mt. Clemens	1.1	-27.4	-26.5
Ferndale	0.4	-37.2	-37.0

The third group in Table 9 includes districts where the positive budgetary impact of foundation allowance growth has been overwhelmed by falling enrollments. Despite receiving substantially more money per pupil from the state, the total real revenue available for local schools in districts including Benton Harbor, Hillsdale and several districts in the Upper Peninsula has fallen under Proposal A, because enrollments have declined faster than the foundation allowance has grown.

A large and growing number of urban districts have experienced significant financial losses as a result of Proposal A.

The fourth group in Table 9 includes districts where slow growth in the foundation allowance has accompanied declining enrollments. In these districts the total revenue available for local schools has fallen rapidly. A large and growing number of urban districts have experienced significant financial losses as a result of Proposal A. In districts including Detroit, Flint, Lansing, Ferndale, and Mt. Clemens long-term demographic trends and very small increases in the real foundation allowance have produced severe budget problems.

To see how patterns of revenue change under Proposal A have affected different communities in Michigan, we created a simple classification of school districts based on geographical and socioeconomic characteristics. Table 10 displays the five community types as well as several descriptive measures characterizing the districts in each group.¹⁴

Table 10

District Characteristics by Community Type, 2001

	Central city	Low- income suburb	Middle- income suburb	High- income suburb	Rural
Number of districts	15	18	195	29	297
Total enrollment	304,088	41,213	647,175	237,681	345,629
% of state enrollment	19.3	2.6	41.1	15.1	21.9
Mean district enrollment	20,273	2,290	3,319	8,196	1,164
% African-American*	65.6	41.9	7.3	3.7	1.3
% Poor*	59.6	59.8	20.6	6.3	32.5
Median Family Income* (1990)	\$24,805	25,219	41,470	55,812	31,019

*These figures are pupil-weighted means, so a district with 10,000 students is given twice the weight of a 5,000-student district.

¹⁴ The methodology for classifying school districts is described in the Appendix.

Consider first the distribution of Michigan's students across community types. Roughly speaking, about one-fifth of the state's students attend central city school districts, another fifth attend rural school districts, and the remaining three-fifths attend suburban districts.¹⁵ Given the diversity of suburban districts, we further disaggregate this group into low-income, middle-income, and high-income suburbs.

Two-thirds of all students in Michigan's fifteen central city school districts are African-American, and 60 percent are poor. The eighteen low-income suburban districts are relatively small and generally located adjacent to the urban core. The socioeconomic characteristics of these districts are similar to those of central cities. Rural areas fall between the suburbs and the urban core on socioeconomic measures. The average income in rural districts is above that of central cities and low-income suburbs, but substantially below income levels in middle- and high-income suburbs. Some of the high-income suburban communities are small, established residential enclaves, but many are relatively large and rapidly growing districts on the outskirts of the state's metropolitan areas.

Table 11 displays patterns of change in enrollments, real foundation allowances, and total real revenues in these five groups of school districts.¹⁶ The data in Table 11 represent average trends across groups. Within each group, of course, there is a range of experiences across individual districts. The table nevertheless makes clear that there are large and systematic variations in Proposal A's impacts across different kinds of communities in Michigan.

As a group, rural school districts enjoyed exceptional increases in the real value of their per pupil foundation grants following the adoption of Proposal A. The fiscal advantage of rapid growth in per pupil revenue was muted by enrollment decline in rural Michigan, but on balance rural districts still enjoyed solid increases in real total foundation revenue.

The experience of central city and low-income suburban districts was very different. On the one hand, central cities and low-income suburbs lost students at roughly three times the rate of rural districts. On the other hand, their foundation grants increased at less than one-third the rate of rural districts. Enrollment decline overwhelmed the fiscal benefits of modest foundation increases in both central cities and low-income suburbs. In both groups of districts total real foundation revenue has fallen significantly since the adoption of Proposal A.

In Michigan's middle-income suburbs, the average real value of the foundation allowance grew at a rate slightly higher rate than in central cities, but far below the rate in rural areas. Enrollments also increased in middle-income suburban districts, however, and total real foundation revenue increased as well.

¹⁵ These shares correspond to students attending the state's 555 school districts. They do not include charter school, private school, or home school students.

¹⁶ The figures in Table 11 differ from those in Table 9, because they are growth rates rather than percentage changes.

The challenges faced by high-income suburban districts under Proposal A have received a fair amount of media attention. Because these districts were able to generate lots of local revenue before the implementation of Proposal A, their foundation increases since 1994 have been relatively small. Indeed, the average real foundation growth rate for high-income suburban districts has been slightly negative. At the same time, however, the high-income suburban districts have experienced the fastest enrollment growth of any school district group. The combination of rapid enrollment growth and foundation growth at just about the rate of inflation generated an overall growth in total foundation revenue in high-income suburbs that exceeded that of any other group of school districts.¹⁷

Table 11
Growth of Foundation Grants and Enrollment
by School District Type

Average Annual Growth Rate 1994 to 2002			
<u>School district type</u>	<u>Real per pupil foundation grant</u>	<u>State aid pupil count</u>	<u>Total foundation revenue</u>
Central city	0.80	-1.64	-0.84
Low-income suburb	0.79	-2.16	-1.37
Middle-income suburb	0.99	0.51	1.50
High-income suburb	-0.01	2.20	2.19
Rural	2.47	-0.58	1.89

Note: All growth rates are derived from pupil-weighted means for each school district grouping.

The greatest fiscal stress under Proposal A has been felt in urban school districts and in those rural districts with very sharp enrollment declines, including many in the Upper Peninsula. The demographic forces that underlie these enrollment shifts are likely to continue. Michigan's school-aged population is shifting from rural and poorer urban areas to suburban districts, and from older suburbs to newer suburbs on the periphery of the state's metropolitan areas.

Proposal A facilitates this population shift, because school funding follows students as they move. At the same time, Proposal A also forces reductions in educational services

¹⁷ This statewide trend for high-income districts, however, does not diminish the strain experienced in those affluent suburbs (for example, Okemos and Bloomfield Hills) that have suffered enrollment losses under Proposal A.

in districts where enrollment is declining.¹⁸ Newer suburban districts receive large infusions of additional funds to expand their educational offerings, while older urban communities must make staffing and program cuts. These school budgetary changes, in turn, influence households' perceptions of the condition of local schools. School closures and teacher layoffs can create negative perceptions that enhance the prospect that additional families will leave a community, creating a self-reinforcing cycle. For these reasons, Proposal A may not only respond to suburban sprawl, but encourage it as well.

In the long run, school districts must adjust to enrollment changes. Proposal A, however, exacerbates the difficulty of budgetary adjustments. Spending in declining-enrollment districts cannot be reduced fast enough to match falling revenues without damaging educational programs, because some costs are essentially fixed in the short run.

By way of illustration, consider the following example based on the Livonia school district. Suppose the district lost one student from every elementary classroom and one secondary school student from every class during a representative class period of the day. This would reduce enrollments by the equivalent of 743 full-time students, or a loss of over \$5 million to the district at its current foundation allowance of \$8105. Yet under this scenario, district costs would scarcely be affected by the enrollment declines. In order to reduce spending in line with the drop in revenue, services and programs for students remaining in the district would have to be cut back.

The cost squeeze that accompanies declining enrollment under Proposal A is muted when per pupil foundation allowances are rising rapidly. It is especially acute, as now, when foundation allowances are stagnant or declining. We return to this issue in our discussion of policy issues in Chapter IV.

The Changing Distribution of High-Cost Students

Proposal A aimed to reduce inequities in revenues, but it took virtually no account of differences in the cost of providing education services. If policymakers seek to encourage efficiency across a system of schools, then state funding must account for differences in the costs that local districts confront. In addition to the problems posed by declining enrollment, two sources of cost differentials are particularly relevant: those related to regional difference in the cost of living, and those related to the added cost of serving special needs students.

The cost of living varies substantially across regions in Michigan, and this translates into differentials among school districts in the cost of providing educational services. In general, costs tend to be higher in urban than in rural areas. Rural school districts face higher costs per pupil for transportation services, but personnel costs account for most of

¹⁸ Prior to Proposal A, Michigan's system of school finance eased the adjustment process in declining-enrollment districts somewhat, because local property tax revenues tended to fall less rapidly than educational costs as enrollment fell.

school operating expenditures. Prevailing wages and home prices are much higher in metropolitan Detroit than in most rural areas, and operating costs for metropolitan area school districts are higher in consequence. Unlike several other states, Michigan's school funding system provides no compensation for regional cost of living differences.

The special services required by students with disabilities or those "at-risk" due to family and community poverty entail substantial additional expense. Michigan's funding system accounts for only a portion of the added cost of these services through categorical funding.¹⁹ Since Proposal A prevents districts from obtaining additional revenue from local voters, the uncompensated expense of serving high-cost students may diminish funds available for regular education students.

If all districts enrolled the same percentage of children with special needs, the added burden of educating these students would be equitably shared across districts. When some districts enroll a larger share of children with special needs than other districts, however, these districts face a disproportionate financial burden. This is what has happened in Michigan since the adoption of Proposal A.

¹⁹ The right of students with disabilities to free and appropriate services is protected under the federal Individuals with Disabilities Education Act. Michigan reimburses only 28.6 percent of allowable special education costs incurred by local districts, a reimbursement rate that is very low by comparison to other states. Michigan districts serving high concentrations of students from families in poverty (measured by eligibility for free lunches) receive additional categorical funding at the rate of 11.5 percent (a 1.115 per pupil weight) of their foundation allowance. Only districts with 1993-94 per pupil revenue under \$6500 are eligible for these "at-risk" funds.

Table 12

Shifts in Composition of Student Enrollment in Growing and Declining Districts

% Change enrollment <u>1994-2001</u>	Number of <u>districts</u>	% Special education		Change in % special ed
		<u>1995</u>	<u>2001</u>	<u>1995-2001</u>
< -20%	31	12.0	16.8	4.8
-20% to -5%	177	11.7	15.0	3.3
-5% to 5%	168	10.7	13.0	2.3
5% to 20%	133	9.9	11.5	1.6
> 20%	45	9.6	11.6	2.0
Total	554	10.9	13.3	2.4

		% Poor		Change in % poor
		<u>1995</u>	<u>2001</u>	<u>1995-2001</u>
< -20%	31	52.4	57.1	4.7
-20% to -5%	177	44.7	46.2	1.5
-5% to 5%	168	21.5	22.9	1.4
5% to 20%	133	16.2	16.5	0.3
> 20%	45	13.4	13.3	-0.1
Total	554	30.4	30.2	-0.2

A striking feature of the distribution of high- and low-cost students across Michigan schools is that it is systematically related to district enrollment change. Table 12 shows that there is a strong association between the pace of district enrollment change and the share of students who are high cost. The faster a district loses students, the larger the increase in the share of remaining students who are poor or who have disabilities. This suggests that the children leaving declining-enrollment districts are more likely to be lower-cost students, while those left behind are disproportionately high-cost students. This change in student composition clearly intensifies the fiscal strain in declining-enrollment districts. A rising share of high-cost students squeezes school budgets, hastening cuts in educational programs and services. Service cuts in turn encourage additional families to leave the district, which brings about further reductions in school revenues.

Recent state and federal legislation, including No Child Left Behind, has defined and mandated high levels of achievement for all students. A key question in school finance policy and litigation is whether the resources that the state provides to public schools and

school districts are **adequate** to accomplish these ambitious educational goals. The standard of “adequacy” will vary across schools and across students, because the cost of ensuring high achievement will be higher for some students than for others. Districts in high-cost regions and districts enrolling disproportionate concentrations of high-cost students may require additional resources if they are to meet state accountability standards.

After ten years, Michigan’s school finance system is under increasing strain.

Conclusions

Between 1994 and 2002, Proposal A was associated with modest growth of average per pupil spending in the state. It also substantially reduced inequality across districts. After ten years, however, Michigan’s school finance system is under increasing strain, for two main reasons.

First, there are growing concerns about the stability and adequacy of the revenues that flow into the state’s school aid fund. Under Proposal A, Michigan’s school funding is more vulnerable to business cycle fluctuations, as recent declines in the value of the per pupil foundation allowance demonstrate. In addition, the state’s SAF has relied on substantial transfers of revenue from the state’s General Fund. Transfers on this scale will be difficult to sustain in light of the structural deficit in the General Fund.

Second, Proposal A does not adequately address potentially large mismatches between the revenues that districts receive and the costs that they must bear. This problem has three key dimensions, which are attributable to declining district enrollment, concentrations of high-cost students, and regional cost of living differences.

Proposal A has affected different school districts in different ways. The reform generated large increases in per pupil funding in over 300 school districts, particularly formerly low-revenue districts in rural areas. In addition, until the state’s current fiscal crisis, foundation allowance growth in suburban areas surpassed inflation in all but the highest-revenue districts. At the same time, the fiscal circumstances of districts throughout the state have come to depend heavily on the local rate of enrollment growth or decline.

Our analyses show that Michigan’s urban school districts have been especially hard pressed under Proposal A, because of (1) relatively slow foundation allowance growth, (2) rapid enrollment loss, and (3) a rising share of students who are high-cost. These elements were producing fiscal stress in urban school districts even before the current budget crisis arrived.

In the following chapter we suggest policy changes that would help to ensure that Michigan can continue to provide adequate funding for all schools and students, while protecting the equity and efficiency gains that Proposal A has brought to the state’s education system.

IV. CURRENT ISSUES IN SCHOOL FINANCE POLICY

We begin from the premise that the policy framework defined by Proposal A has generally worked well for Michigan’s schools and taxpayers. Property taxes have been significantly reduced, and the financial disparities between Michigan’s highest and lowest spending school districts have been reduced as well. These are major accomplishments, which policy-makers should strive to protect.

The overall good that Proposal A has produced does not mean that Michigan’s school finance policies cannot be improved. The Legislature has already made a variety of changes in Proposal A concerning the rules for establishing student counts. Further changes in Proposal A could help to address other critical issues in Michigan school finance and make Michigan’s school funding system work even better. The changes that we propose would protect the gains that Michigan has experienced as a result of Proposal A, while easing some of the financial and administrative burdens that Proposal A has imposed on schools and school districts.

In the current debate about “tweaking” Proposal A, one basic policy question must be addressed directly. Much of this debate has focused on the question whether local school districts should be given the opportunity to increase their revenues by restoring their right to levy property taxes to support local schools. There is growing political pressure to permit “enhancement millages” in several parts of the state, including districts that have experienced revenue losses under Proposal A as well as districts that have not “won” as much as they would like.

Reintroducing local property taxes to support local schools is a bad idea.

Our answer to this question is an emphatic “no.” Reintroducing local property taxes to support local schools is a bad idea. It would quickly unravel the gains that have been accomplished by Proposal A, to the benefit of a relatively small—and, for the most part, relatively wealthy—set of school districts.

In our view there are two key features of Proposal A that merit legislative attention. The first is the problem of adequacy, stability and growth in system-wide revenue. This problem has two main dimensions. On the one hand, the revenues that flow into the School Aid Fund (SAF) have consistently fallen short of the spending promises made by the Legislature, and they will continue to do so without structural changes in Proposal A. On the other hand, the shift from property taxes to sales and income taxes as the principal revenue source for Michigan’s education system has increased the vulnerability of school funding to business cycle fluctuations.

The second problem with Proposal A is the mismatch that it creates between revenues and costs. This problem also has two dimensions. On the one hand, Proposal A poses a

serious challenge for districts where enrollment is declining. Many of these districts are in rural areas or in low-income urban centers. Enrollment decline is driven mainly by long-term population shifts, but it has been encouraged and accelerated by public policies including Proposal A. On the other hand, Proposal A fails to acknowledge the different cost of educating different kinds of students. This exacerbates the difficulties of schools and school districts that educate a disproportionate share of high-cost students, and of those that operate in high-cost regions of the state. The fact that declining-enrollment districts also educate a disproportionate share of high-cost students serves only to reinforce their fiscal plight.

Some necessary reforms in Proposal A may help address immediate revenue needs and simultaneously increase the long-term performance of the public school system.

The urgency of the state’s current budget crisis is likely to distract the attention of policy-makers from longer-term issues in Michigan school finance. As the state confronts immediate budget shortfalls, however, it makes sense to address these in ways that strengthen rather than undermine the long-term equity, adequacy, and efficiency of Michigan’s system for funding its schools. Some necessary reforms in Proposal A may help address immediate revenue needs and simultaneously increase the long-term performance of the public school system. Before addressing the possibility of structural reforms in Proposal A, therefore, we briefly discuss state and local responses to Michigan’s current budget crisis.

A. Responding to the Current Budget Crisis

1. Funding reductions

School finance is once again at the top of the policy agenda in Michigan, as the state faces its worst budget crisis in half a century. In the 2003 fiscal year, a revenue shortfall in the SAF has produced the first reductions in foundation support for Michigan school districts since Proposal A was approved in 1994. The projected revenue shortfall for the 2004 fiscal year is even larger, which could require even deeper cuts.

For the 2003 fiscal year, Governor Granholm issued a directive that reduced school funding by \$127 million through a *pro-rata* cut of 3.8 percent in the state’s non-constitutional funding for Michigan schools. The 2003 budget adopted by the Michigan Legislature called for restoring these cuts and avoiding cuts in the foundation allowance for the 2004 fiscal year. Whether this can be accomplished depends on how Michigan’s economy performs in the next several months. There is a good chance that the Legislature may once again need to decide how to distribute budget cuts across school districts.

This is not a simple problem, because there is no uniquely “fair” way to assign the cuts. Different strategies will have larger effects in some districts than in others. Should the districts that benefited most from Proposal A give back some of their winnings, thus

surrendering some of the equity gains from Proposal A? Or, should the districts that have lost ground since the approval of Proposal A bear additional losses, further damaging the educational opportunities available to local children?

If they fail to address structural problems in the adequacy and stability of the SAF, state policymakers will confront equally hard choices for how to implement budget cuts in years to come.

Pro rata cuts were the only option available in fiscal year 2003. Alternative strategies for cutting expenditures would have required action by the Legislature, and the Legislature could not agree on an alternative approach. For 2004, however, deliberations are underway to find a “fairer” way to distribute anticipated budget cuts across Michigan’s school districts.

We consider alternative mechanisms for state education funding cuts below. Their relevance may extend beyond the current budget crisis. If they fail to address structural problems in the adequacy and stability of the SAF, state policymakers will confront equally hard choices for how to implement budget cuts in years to come.

Pro-rata reduction

Pro-rata cuts are percentage reductions in the state’s non-constitutional funding for schools. Two major sources of school funding, constitutionally protected funding and funding that the state does not collect, are not subject to *pro-rata* cuts. Under Proposal A, the Michigan Constitution guarantees that no school district will ever receive less revenue than it received from state and local sources in 1994-95. This amount is constitutionally protected, and therefore not subject to pro-ration.²⁰ The most important revenues that the state does not collect come from local property taxes on non-homestead property and “hold harmless” millages collected in the highest-spending school districts. Others include federal grants to school districts and funds distributed as a part of the *Durant* settlement.²¹ Because so many revenue sources are excluded from *pro-rata* cuts, pro-ration requires proportionately larger percentage cuts in unprotected revenues to generate any given level of savings for the state budget.

Budget cuts based on pro-ration hit the poorest school districts especially hard, for two main reasons. First, in Michigan’s high-spending school districts the share of educational revenue that is constitutionally protected is relatively high. These districts also collect substantial supplemental revenue locally through “hold harmless” millages. In consequence, *pro-rata* cuts produce minimal revenue losses in districts like Bloomfield Hills and Birmingham, and much larger losses in poor districts that receive more of their revenue from the state.

²⁰ The amount ranges from \$4200 in Onaway and many other rural districts to over \$10,000 in Birmingham and Bloomfield Hills.

²¹ In *Durant v. State of Michigan*, the Michigan Supreme Court ruled against the state in a 17-year struggle over special education funding and directed the state to pay more than \$200 million to 83 school districts and one ISD.

Second, high-poverty school districts depend on categorical programs including “at-risk” funding to a far greater extent than wealthier districts. Categorical grants from the state are subject to *pro-rata* reductions, which cut revenues in the poorest school districts even further.

In addition, pro-ration produces large and arbitrary variations in the size of budget cuts across districts, based on the percentage of their property wealth that is non-homestead property. School districts that house valuable non-homestead property collect a large share of their total revenues locally. As a result, only a relatively small share of their total revenue is subject to a *pro-rata* cut. A school district where a power plant is located, for example, may receive virtually no state revenues to support local schools, so pro-ration has a very small impact on total revenues. In districts where non-homestead property is of little value, in contrast, most educational revenues come from the state. In these districts a larger share of total revenue is subject to pro-ration, and *pro rata* cuts have a much larger impact.

Uniform dollar reduction

Another way to distribute budget cuts would be to reduce revenues in all school districts by the same absolute dollar amount per pupil.²² If this strategy had been adopted during the 2003 fiscal year instead of pro-ration, it would have amounted to a cut of roughly \$69 per pupil in all Michigan school districts. Reducing all district budgets by the same per pupil amount would impose larger costs on most wealthy districts than *pro rata* cuts, because the constitutional protections that exempt much of their revenue from pro-ration would not apply. In percentage terms, however, uniform per-pupil reductions require larger budget cuts in low-revenue than in high-revenue school districts.

Uniform percentage reduction

A third alternative would cut the per pupil foundation allowance in all Michigan school districts by the same percentage. Under this alternative, high-revenue districts would return more to the state than low-revenue districts, for the obvious reason that their budgets are larger. With a 1 percent cut, for example, a district with foundation revenue of \$10,000 per pupil would return \$100 per pupil, while a district with foundation revenue of \$6700 would return \$67 per pupil.

Exempting specific revenue sources

In addition to these possibilities, the Legislature could exempt specific revenue sources from required budget reductions. Exempting categorical grants targeted to high-cost students makes good sense, on both equity and efficiency grounds. In her budget proposal for 2003, for example, Governor Granholm sought to protect funding for the “at risk” categorical grant from cuts, on the ground that school districts that educate large numbers of poor children face the greatest challenges and the highest costs.

²² A bill that would establish this as the rule for future budget reductions under Proposal A passed the Michigan House of Representatives in 2003.

Policy Recommendation

The key question that the Legislature must answer in considering budget reductions is whether the equity gains produced by Proposal A when revenues were rising will be further enhanced, protected, or reversed now that revenues have begun to fall. In our view, two principles should guide decisions about budget cuts.

- First, revenue cuts should not be influenced by arbitrary district characteristics – that is, characteristics that are unrelated to educational costs or needs.
- Second, revenue cuts should not fall disproportionately on low-income districts, because they face the state’s greatest educational challenges.

The key question that the Legislature must answer in considering budget reductions is whether the equity gains produced by Proposal A when revenues were rising will be further enhanced, protected, or reversed now that revenues have begun to fall.

By both of these criteria, uniform dollar reductions and uniform percentage reductions are superior to *pro rata* cuts. In recent budget negotiations, the Legislature established uniform dollar reductions as the basis for future revenue cuts, but either one of these options is defensible. Regardless of which alternative is chosen, the revenue base on which reductions are imposed should exclude categorical funding targeted to the education of high-cost students (particularly funding for special education and “at-risk” students) in order to avoid further damage to Michigan’s neediest students and schools.

2. Enhancing Revenue and Increasing Efficiency

Faced with the prospect of declining revenues, most Michigan school districts have begun to respond in familiar ways: closing schools, reconfiguring grades, laying off teachers and eliminating innovative programs. Cutting local budgets in these ways may do significant damage to the quality of education that Michigan children receive.

While cutting programs and laying off teachers are not the most desirable responses to the current budget crisis, most districts have enjoyed limited success in identifying alternative strategies that might protect or even enhance the educational opportunities provided to local children. As state support for education stagnates or declines, however, there are ways in which local actors can enhance revenues or increase efficiency in order to improve the educational services that they provide.

Revenue enhancement: ISD Millages

As noted above, Proposal A permits school districts in an Intermediate School District (ISD) to levy up to three additional mills on property within the ISD with the approval of local voters. The enhancement millage must be approved by a majority of voters in the

ISD, and the new revenues must be distributed across all of the constituent school districts in the ISD on a uniform per pupil basis. The value of a mill ranges from just under \$100 to over \$300 per pupil across the 57 ISDs in Michigan.

In the Kent ISD, for example, levying one mill on property would yield approximately \$171 per pupil. This one mill levy would produce more than \$3.5 million per year for the Grand Rapids Public Schools, and more than \$500,000 per year for districts including Northview, Lowell, and Kenowa Hills. Levying three mills would produce three times as much revenue. New revenues from ISD millages could help school districts to avoid the most damaging consequences of the present budget crisis.

Increased efficiency: Consolidation and Shared Services

Despite the tradition of local control in Michigan's public school system, there is growing recognition that cooperative ventures involving multiple schools and school districts can enhance efficiency and service quality. It no longer makes sense for all Michigan school districts to provide a full array of services—from transportation to payroll administration to Advanced Placement courses—"in house." Finding ways to share resources across district boundaries may provide cost savings, and expand the educational opportunities available to many students. In a period of declining budgets, taking advantage of these opportunities should be an urgent priority.

One possibility is consolidation, in which two or more local school districts agree to merge into a single, larger district. There are many steps that can be taken short of full consolidation, however. These include sharing administrative and other services, and providing joint instructional programs (on-site or on-line). Some of these arrangements can be established through bi-lateral or multi-lateral cooperation among districts. Others may require leadership and coordination through the ISDs.

Michigan families are demanding an ever-expanding array of specialized educational experiences for their children (e.g., science and technology intensive programs, alternative education, advanced placement courses, compensatory education, vocational education, expanded foreign language instruction). While educators may agree on the educational merit of such programs, providing them can be prohibitively expensive for individual districts.

Cooperative ventures among districts may offer real savings in program costs and significant benefits for students in public schools. Taking advantage of these opportunities would require districts to work together and share resources in unfamiliar ways. This might pose political challenges, but in a period of increasingly tight budgets the familiar alternatives are surely worse.

B. Stability, Adequacy, and the General Fund Gap

Under Michigan's centralized system of school finance, the fiscal prospects of every school district in the state depend on the stability and growth of the revenue streams

flowing into the School Aid Fund (SAF). With respect to stability, it is desirable for the SAF to rely on revenue sources that do not vary dramatically over the course of the business cycle. Stability in the SAF makes it possible for school districts to budget and plan on the basis of realistic revenue estimates. With respect to growth, the SAF should expand over time as economic activity and incomes in the state expand. Steady growth in the revenue base of the SAF is necessary to ensure that the funds available for school districts are adequate to meet the rising cost of educating Michigan students. The current budget crisis makes it clear that the stability and adequacy of funding for Michigan's schools under Proposal A need to be improved.

1. Stability of revenue sources

The SAF now relies very heavily on relatively volatile funding sources including income and sales taxes. As the present budget crisis demonstrates, reliance on revenues from these sources leaves the SAF vulnerable to economic downturns. Shifting the mix of taxes that go into the SAF to include greater reliance on property taxes would provide greater revenue stability for Michigan's schools. In contrast to revenues from sales and income taxes, state education property tax collections have continued to grow right through the recession.

2. Adequacy of SAF revenues

In every year since Proposal A was approved, the Legislature has had to appropriate a significant amount of General Fund money to "top up" the funds available in the SAF in order to finance increases in foundation allowances. In the past two years the Legislature has also provided significant revenues from the Budget Stabilization Fund and other sources to meet budgetary promises to school districts. Eliminating the General Fund "gap" in the SAF would require earmarking additional revenue sources for schools.

Policy recommendation

In our view, the best way to increase the stability of the SAF would be to increase the statewide education property tax rate, with the new revenues earmarked for the SAF. Increasing the statewide property tax on homestead and non-homestead property from six to eight mills, for example, would generate approximately \$600 million per year. A property tax increase of this magnitude would sustain the modest rate of revenue growth received by Michigan schools between 1994 and 2002, but not increase it further.

This shift would have four desirable consequences. First, it would make education funding less vulnerable to cyclical changes in Michigan's economy, making revenues for schools more predictable over time. Second, it would support growth in the SAF, because the current state education property tax has been more responsive to long term growth in state economic activity than other taxes earmarked for the SAF. Third, it could be structured to eliminate the General Fund "gap" in the SAF, replacing annual appropriations from the Legislature with earmarked revenues. Finally, assigning these new revenues to the SAF would ease the current pressure on the General Fund, freeing

revenue for other purposes of state government that are virtually certain to face serious cuts in the next year or so.

An increase in the statewide property tax would probably require a vote of the people. For the owner of an average home with a market value of \$128,000, state equalized value of \$64,000, and taxable value of \$50,000, two additional mills would raise annual property tax payments by \$100. This compares to Proposal A's property tax cut on the same home of \$2,000 per year.²³ The actual income forgone by the taxpayer in this example would in fact be significantly less than \$100, because property tax payments, unlike sales taxes, are deductible from federal income taxes. In effect, the federal government would subsidize roughly a quarter of the state's additional revenue collection.²⁴

C. The Mismatch Between Revenues and Costs

The revenues that school districts receive from the state under Proposal A may not always meet the cost of providing an adequate education for local students, for two main reasons. On the one hand, the value of the foundation allowance is the same for all students in a school district or charter school, even though the cost of providing an adequate education can be far higher for some students than for others. Categorical grants defray some of these additional costs, but school districts and charter schools that educate a disproportionate share of high-cost students may nevertheless find themselves at a severe financial disadvantage. Moreover, costs are higher in some regions of the state than in others, which may also justify differential funding. On the other hand, revenues fall much faster than costs in school districts where enrollment is declining. The resulting mismatch between revenues and costs makes it difficult to provide an adequate education for the students who remain enrolled.

1. Cost – Based Funding

State funding now creates an incentive for schools to specialize in the education of low-cost students.

In contrast to the school funding formulas in several other states, Michigan's school aid is not adjusted for the different cost of living (and running schools) in different parts of the state, nor does it fully acknowledge the differential cost of educating different kinds of students (e.g., elementary versus secondary students, children with special needs). Taking fuller account of cost differentials in the distribution of state school aid would offer two key benefits.

First, it would address the concerns expressed by schools and school districts in high-cost regions of Michigan that the revenues

²³ This example relies on the Michigan Department of Treasury's estimate of the market and taxable values for the average Michigan home and the estimated annual property tax saving for this property in 2002 as a result of Proposal A.

²⁴ The actual subsidy for individual taxpayers would depend on their marginal tax rate under the federal income tax. For taxpayers who itemize deductions, the higher one's tax bracket the larger the percentage of property tax payments the federal government would pay.

they receive from the state fall short of the amounts needed to meet their educational responsibilities. Second, adjusting state funding to reflect cost differences among students would make Michigan's increasingly market-based education system work more fairly and efficiently. State funding now creates an incentive for schools to specialize in the education of low-cost students. Cost-based funding would work against this incentive by compensating school districts and charter schools that take on the greatest challenges in the state's education system.

Policy Recommendation

There are two ways to address the mismatch between revenues and costs under Proposal A. On the one hand, the Legislature could adopt a weighted-pupil count, under which the value of the per pupil foundation allowance would be adjusted to reflect variability in the cost of providing an adequate education for different students. For example, a larger weight in the funding formula might be assigned to high school students, or to students with special needs, or to students attending schools in high-cost areas. The districts and charter schools where these students are enrolled would receive a larger per pupil foundation allowance to meet the higher cost of educating them. Alternatively, the state could increase the quantity of categorical funding that it targets to high-cost students and high-cost areas.

2. Transitional support for declining-enrollment districts

Providing transitional support to school districts where enrollment is declining would make it possible for these districts to respond more thoughtfully and deliberately to revenue reductions over time. Under the present system, falling enrollment can launch an accelerating downward spiral in local school districts, as budget reductions lead to program cuts and further enrollment declines. One Michigan school district has already "gone bankrupt," and a growing number of others are in danger of doing so.

Pupil counts used for the distribution of foundation revenue are based on a blend of the current and previous year's enrollment. In 1995, the head count procedure assigned a weight of 0.5 for enrollment in the previous spring and 0.5 for the current year. By 2002, the state's "blended" pupil count gave weights of 0.2 for the previous year's enrollment and 0.8 the current year's. These changes have increased the fiscal strain on declining-enrollment districts.²⁵

As noted in Section III, declining enrollment in Michigan is primarily concentrated in rural and urban school districts. The Legislature has already enacted changes in head count procedures to ease the financial plight of declining-enrollment rural districts. Since 2000, districts with fewer than 1500 students and enrollment density of less than 4.5 students per square mile have been able to calculate their pupil count as the average of the prior three years, if that generates a higher figure than the standard blended count.

²⁵ In her proposed FY04 budget, Governor Granholm called for pupil count weights to be restored to 50 percent based on last year's enrollment and 50 percent on the current year's enrollment. The legislature rejected this change. The current formula favors districts where enrollments are stable or increasing.

The 3-year average enables these small rural districts to phase in their budgetary cuts more gradually than larger districts are required to do.²⁶

Policy Recommendations

In our view, the best way to address the problems faced by declining-enrollment districts would be to increase the weight of past-year enrollments in the formula for counting pupils, which would help districts to minimize the damaging effects of rapid enrollment decline. The Legislature has already approved three-year enrollment averaging for declining-enrollment rural school districts. At a minimum, this opportunity should be extended to all districts. Declining-enrollment school districts could also receive targeted categorical grants to reduce the danger of an accelerating spiral of decline, but this is a less attractive option.

D. Funding for school infrastructure

The question of infrastructure funding has received a lot of attention in recent discussions of Proposal A and Michigan school finance.²⁷ This is a critically important problem, but it has nothing to do with Proposal A. Proposal A changed the way that Michigan funds the operation of our schools. It did not address the way that we fund school infrastructure.

Capital spending has increased dramatically in Michigan school districts since 1994, in part because the reduction in property taxes brought about by Proposal A made voters less hostile to new bond issues. This increase has not benefited all districts, however; in fact, it has increased the distance between those school districts with adequate facilities and those without. Michigan remains one of the few states that does not provide some form of subsidization for capital costs in low-property-wealth districts.

Inequalities in capital funding are vastly greater than inequities in operational funding ever were.

Capital expenditure for school construction and other investments continues to rely entirely on local property tax revenue. As a result, school districts that are home to expensive residential property or valuable commercial/industrial property are able to build marvelous schools. Districts that lack these advantages are unable to repair decaying buildings constructed in the nineteenth century. Inequities in capital funding are vastly greater than inequities in operational funding ever were, because the state makes almost no effort to supplement local resources when it comes to capital spending.

²⁶ The population density threshold of 4.5 is so low that it also precludes many rural declining-enrollment districts from taking advantage of the 3-year blended count average.

²⁷ See “From Proposal A to Proposal A+: A discussion of issues and options regarding the financial requirements of public education in Michigan,” Report to the State Board of Education from Tom Watkins, Superintendent of Public Instruction and the School Finance Task Force, March 2002. See also the follow-up report, “Financing Michigan’s Public Schools: Requirements, Issues, and Options,” October 2002.

Ensuring adequate school facilities for all Michigan students will require new legislation and new state revenues, independent of any changes that may be made in Proposal A. The Education Policy Center and the Citizens Research Council are currently conducting research aimed at assessing the scale of Michigan's infrastructure needs and identifying policy options for addressing these. A report based on this study will be published in 2004.

V. CONCLUSION: PRESERVING PROPOSAL A

On balance, the dramatic changes brought about by Proposal A have been decidedly positive. Proposal A led to a significant reduction in property taxes, while simultaneously reducing inequities in the way Michigan funds its schools. The financial framework defined by Proposal A provides a sound basis for continued improvement in the equity and effectiveness of Michigan's education system.

At the same time, Proposal A marks an unprecedented shift of power in Michigan's education system, from local to state actors. In the past, local citizens and educators played the leading role in decisions about local schools, including the level of funding. Communities could approve millages that reflected their preferences for education or responded to distinctive local costs. Economists have long celebrated this local flexibility as enhancing the overall efficiency of a state's K-12 education system.

The danger in the present moment is that political pressure from these communities will begin to undo the central accomplishments of Proposal A.

Under Proposal A, local authorities have lost the power to respond to local demands for more (or less) spending on schools. Instead they must look to Lansing. Now the key actors are state legislators and other groups influential at the state level. Proposal A also implicitly tied school funding to a wide range of other public policy issues. Decisions on questions ranging from business taxation to the payment of medical benefits for families that lack private health insurance to incarceration guidelines for the state's prisons now affect the resources available for local schools.

Discontent with the loss of local control over the quantity of resources available for local schools remains muted so long as funding is expanding. When funding is stagnant or declining, however, displeasure increases. With the present budget crisis in Michigan, the number of school districts that perceive themselves to be "losers" under Proposal A

has grown dramatically. The danger in the present moment is that political pressure from these communities will begin to undo the central accomplishments of Proposal A.

To preserve the gains that have been accomplished under Proposal A, we have recommended three major changes in the way Michigan funds its schools.

- The Legislature should take steps to ensure the stability and adequacy of revenues earmarked for the SAF. The best way to do this would be for the state to increase the state education property tax, and to earmark the revenues from this tax to the SAF. This change would support long-term planning for schools and school districts, and protect students from unanticipated budget shortfalls.
- The Legislature should ensure that the basis for distributing revenues to schools and school districts reflects the different cost of educating different students. This is essential on equity and adequacy grounds, because schools facing higher costs must overcome an immediate disadvantage in their efforts to educate children to meet state standards for student performance. A move toward cost-based funding

is also essential in order to limit incentives to specialize in the education of low-cost students in Michigan's increasingly competitive market for schooling.

- The Legislature should take further steps to provide transitional support to school districts where enrollment is declining. The precipitous revenue declines that now accompany falling enrollments are doing severe damage to the quality of education in many school districts. The financial burden that accompanies these declines must be distributed over a longer period, in order to give declining districts an opportunity to adjust to reduced revenues in a more deliberate and effective way.

These proposals reinforce one another. Without additional revenues earmarked for the SAF, there is little chance of addressing declining enrollment and cost differentials in school funding. By the same token, unless the problems of declining enrollment and cost differentials are addressed, it is unlikely that additional SAF revenue will be allocated to the most pressing educational needs.

A two-mill increase in the state property tax earmarked for the SAF would not restore growth in Michigan's education revenues to the rates that prevailed before Proposal A. Nor would it preclude the need for continued austerity among Michigan school districts and schools. It would, however, help to forestall cuts in education programs that will be unavoidable otherwise, at a time when the federal No Child Left Behind legislation has sharply increased performance expectations. It would increase the typical Michigan homeowner's property tax payment by less than 10 percent of the annual value of the property tax saving produced by Proposal A.

In this report we have also argued that the Legislature should resist demands to "tweak" Proposal A by restoring local property taxes as a funding source for local schools. Restoring the local option to levy property taxes to support schools would over time undo many of the equity gains that Proposal A has brought about, to the benefit of a relatively small number of students.

The current budget crisis illuminates some fundamental problems in the way that Michigan now funds its schools. Addressing these problems in the ways that we have suggested will help to preserve the gains that Michigan has accomplished under Proposal A, while ensuring adequate funding for the education of our state's children into the future.

FURTHER READING

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Office of Revenue and Tax Analysis, Michigan Department of Treasury. "School Finance Reform in Michigan. Proposal A: Retrospective." December 2002.

APPENDIX

Data Sources and Methods

Unless otherwise noted the empirical results presented in this report rely on data obtained from the Michigan Department of Education. Data for other states, underlying Tables 4 and 6, were obtained from the U.S. Census Bureau.

The classification of school district types, presented in Tables 10 and 11, utilized National Center for Education Statistics (NCES) data. The NCES classifies school districts using Metropolitan Statistical Areas (MSA) defined by the U.S. Office of Management and Budget.

Our “central city” classification includes school districts that the NCES classifies as primarily serving “Large Cities” and “Mid-size Cities.” The NCES classifies a few suburban districts with extensive employment as “Mid-sized Cities” (e.g., East Lansing, Dearborn, and Kearsley). We classified these districts as suburban.

Our suburban district classifications are based on two criteria: (1) the NCES classifies them as “serving an MSA but not primarily its central city” and (2) they have population density of at least 20 people per square mile. The second condition is necessary because MSAs follow county boundaries which may include outlying rural areas. Our “high-income suburb” classification includes suburban districts with median home value in 1990 greater than \$95,000. Our “low-income suburb” classification includes suburban districts with median home value in 1990 of less than \$42,000. Our “middle-income suburb” group includes suburban districts with median home value in 1990 greater than or equal to \$42,000 and less than or equal to \$95,000.

Our “rural” district group includes those classified by the NCES as “outside an MSA” plus those within an MSA with population density of less than 20 people per square mile.