December 2012

**Pat Sorenson**, Senior Policy Analyst

# Replacing Revenue Key to Successful PPT Overhaul

## More Cuts or More Tax Shifts to Individuals Not the Answer

### MICHIGAN CANNOT AFFORD TO FURTHER REDUCE FUNDING FOR VITAL PUBLIC SERVICES.

The Michigan Legislature has made the passage of legislation to phase out significant portions of the Personal Property Tax—an *ad valorem* tax paid annually by businesses on equipment, machinery and tools—a top priority during the lame duck legislative session. The elimination or reduction of the PPT, without *full* replacement revenue, places local services at risk and could further jeopardize the local infrastructure needed to build a competitive workforce and attract business investments. Full replacement revenue from any change to the PPT is vital and should not be derived from additional cuts in services, or through any additional shifting of the tax burden onto individuals—particularly low- and moderate-income families and taxpayers.

In May, the Michigan Senate passed a package of bills (Senate Bills 1065-1072) that would phase out the PPT on most industrial personal property, as well as a large portion of commercial personal property. It threatens a major revenue source for many local governments and the services they provide, including police and fire protection, local roads and bridges, public parks and libraries as well as K-12 education and community colleges. On Nov. 27, Lt. Gov. Brian Calley, along with Senate Majority Leader Randy Richardville and House Speaker Jase Bolger, presented an alternative plan that attempts to address concerns by local governments and schools regarding guaranteed replacement funding for local services.

In testimony before the House Tax Policy Committee, the lieutenant governor indicated that the bills will include a phase out of the PPT beginning in 2014, a year later than the implementation date in the Senate-passed bills. The changes in the new proposal relate to how local governments and schools are reimbursed for revenues lost. If the PPT phase out is similar to the Senate legislation, the lieutenant governor's proposal could be expected to result in similar revenue losses, which are estimated to exceed $636 million when fully implemented in 2022 (Figure 1). The state can ill afford a revenue loss of this magnitude, particularly in light of the 2011 tax shift from businesses to individuals that created a large net loss in state revenues and made investments in human capital and community infrastructure—a key component of economic growth—even more difficult.

### LOCAL GOVERNMENTAL AND EDUCATIONAL SERVICES ARE MOST AT RISK IF ADEQUATE REVENUES ARE NOT GUARANTEED.

The PPT currently generates nearly $1.3 billion in revenue each year. There are three components of personal property: industrial, commercial and utility. The legislation leaves utility personal property taxes intact, would eliminate commercial personal property liabilities of less than $40,000 for individual taxpayers, and fully repeals the personal property tax on industrial property. Each component generates approximately $400 million annually. Without full replacement revenues, of the expected total revenue loss of $636 million by fiscal year 2022 from the elimination of the PPT, local units of government (counties, cities, townships and villages) would take the biggest hit with a loss of more than $297 million, followed by a loss of state revenues ($124 million), as well as funding for K-12 school districts ($115 million), Intermediate School Districts ($55 million), and community colleges ($27 million). Local governments would absorb nearly half of the revenue losses resulting from the Senate-passed PPT bills, presuming that full replacement revenues are not approved (Figure 2). Of the loss to state funding, two-thirds would come from the State School Aid Fund, while the remainder would be state General Fund (GF/GP) dollars.[1]

FORMERLY THE MICHIGAN LEAGUE FOR HUMAN SERVICES
PROMOTING ECONOMIC SECURITY THROUGH RESEARCH AND ADVOCACY
1223 TURNER STREET • SUITE G1 • LANSING, MICHIGAN 48906
P: 517.487.5436 • F: 517.371.4546 • WWW.MLPP.ORG
A UNITED WAY AGENCY

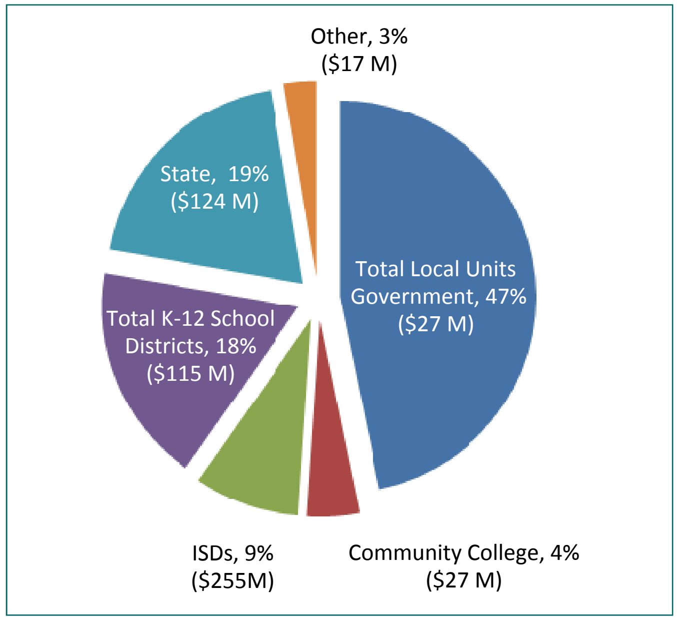
FIGURE 1

**Total Estimated Revenue Loss from Senate Proposal Personal Property Tax (assuming no replacement revenue)**


Source: Senate Fiscal Agency
Produced by Michigan League for Public Policy

FIGURE 2

**Local Governments Absorb Nearly Half of the Revenue Losses Under the Senate-Passed PPT Bill (2022 estimate )**




Source: Senate Fiscal Agency
Produced by Michigan League for Public Policy

## REPLACEMENT REVENUES ARE CRITICAL, BUT CANNOT COME THROUGH ANOTHER TAX SHIFT TO INDIVIDUALS.

The overhaul of the PPT comes on the heels of a major tax shift enacted in 2011 that reduced business taxes by $1.6 billion (83%), while increasing taxes on individuals by 23%. The net result is that two-thirds of Michigan businesses will no longer be subject to taxes, while more than half of Michigan residents will pay more personal income tax.

The lowest-income families (incomes of less than $17,000) are most affected by the 2011 tax shift, paying an average of 1% more in taxes as a percent of their income. The top earners in Michigan ($334,000 or more) will face an average increase of only 0.001%.[2] Individual taxpayers, who are already paying more as a result of the 2011 tax shift, will shoulder a larger share of state and local budgets if PPT revenues are not fully replaced. For example, reductions in PPT funds without replacement revenues would trigger automatic millage increases on homeowners in school districts still legally obligated to repay bonds but without the PPT funds to do so.

Even if local governments and education providers are fully reimbursed, the potential sources that have been identified by state policymakers will shift an even greater burden for state services on individuals, which will be explained in greater depth below.

## CUTS IN THE PPT—WITHOUT FULL PLACEMENT REVENUES—WOULD BE PARTICULARLY DAMAGING TO COMMUNITIES.

Approximately 75% of the funding for local governments comes from local property tax collections (both real estate and personal property), with roughly 25% from unrestricted state revenue sharing. As a result of state budget cuts, less than one-third of the local governments that received statutory revenue sharing payments in the early 2000s receive them today, and state funding (other than that which is Constitutionally guaranteed) to cities, villages and townships, which peaked at $684 million in fiscal year 2001, stands at $225 million in the current year budget—a 67% cut.[3]

If full replacement funding is not guaranteed, the phase out of the PPT will build on the revenue losses already experienced locally as a result of cuts in revenue sharing and the erosion of property values from which property tax revenues are derived, deepen the state's budget and revenue problems in the School Aid Fund, and make it even more difficult to make the investments needed to build Michigan's next workforce, as well as create communities that can attract and retain businesses.

Local governmental and school officials, as well as Michigan voters, recognize the threat:

- In a 2012 poll of Michigan voters, 78% opposed eliminating or significantly cutting the PPT when told it would likely result in cuts in local services such as police, fire protection and schools.

- Nearly three-quarters (74%) of local leaders would support elimination of the PPT *if* the state were to replace the revenues *in full*. However, more than two-thirds would not trust the state to follow through on commitments to replace lost PPT revenues, and would want replacement revenues to be collected and retained at the local level.[4]

- In recognition of the potential crippling of vital services, a number of local governmental and school associations are calling for a constitutional guarantee that revenues lost from a change to the PPT be replaced.

## THE PERSONAL PROPERTY TAX HAS LONG BEEN A SIGNIFICANT SOURCE OF REVENUE FOR LOCAL GOVERNMENTS AND SCHOOLS.

The PPT, which was authorized almost 120 years ago along with property taxes on real estate, is a tax on a range of business assets, including manufacturing and business equipment, furniture, fixtures, tools, computers and other machines. The tax applies only to businesses; residential, charitable, agricultural, educational and certain other properties are exempt. Because manufacturers rely more heavily on expensive equipment, they pay a larger share of PPT taxes.

Currently, most PPT revenues are collected and remain at the local level, and are not appropriated by the Michigan Legislature. Funds are used for county, city, township, and local school services and debt payments, as well as community colleges. Since passage of school finance reform in 1993, the state also receives tax revenues from the PPT through the State Education Tax, with funds going to the School Aid Fund. In 2010, approximately $104 million of PPT revenues were redirected to the state.[5]

The largest portion of the PPT, $457 million or 36% in 2010, was used by counties, cities and townships for operating costs. Local schools received about $226 million (17%) for operations, and an additional $98 million (11%) was used by schools for debt repayment (Figure 3).[6] While there is a great deal of variation statewide, the percentage of a local government, school or community college budget that is funded with the PPT can be sizeable.

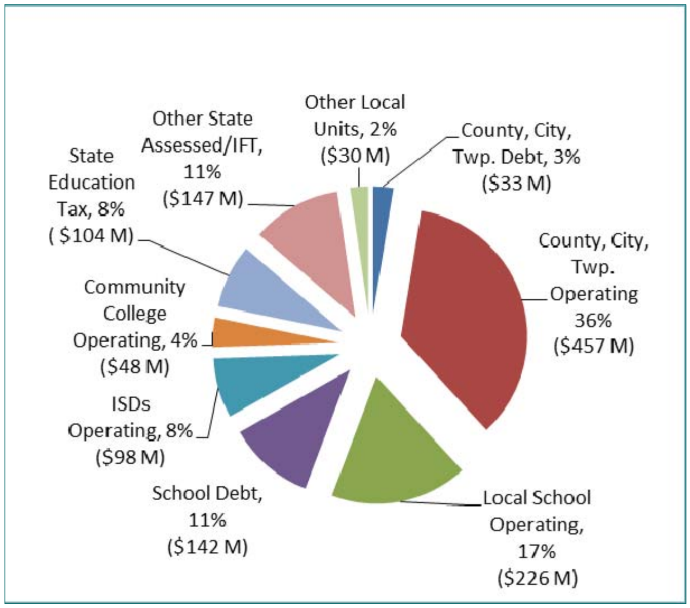
## BOTH PROPOSALS DO NOT GUARANTEE FULL REPLACEMENT FUNDING.

***Both plans would do the following:***

- ***Immediately reduce the number of businesses required to pay personal property taxes:*** Beginning in 2013 (2014 in the lieutenant governor's proposal), industrial and commercial personal property with a taxable value of less than $40,000 ($80,000 true cash value) would be exempt from the PPT. It is estimated that this change would exempt a large number of businesses and reduce state and local revenues by approximately $80 million per year. According to the Senate Fiscal Agency, out of 426 local units where the number of businesses could be estimated, only 62 had an average taxable value per taxpayer of $40,000 or more.[7]

FIGURE 3

**Personal Property Taxes by Source of Levy**
**(2010 Total: $1.28 Billion)**




Source: Senate Fiscal Agency
Produced by Michigan League for Public Policy

- ***Phase out taxes on industrial personal property:*** Beginning in 2016, the remaining taxes on industrial personal property would be phased out by exempting new personal property and phasing out previously existing manufacturing personal property by 2022.

## PPT PROPOSALS VARY IN THE WAY LOCAL GOVERNMENTS AND OTHER LOCAL ENTITIES ARE REIMBURSED FOR REVENUES LOST.

***Senate bills:*** The bills passed by the Senate would require the state to estimate the revenues lost to local governments and educational agencies as a result of the reductions in the PPT to determine the amount by which lost revenues exceeded 2% of General Fund revenues for the local taxing unit (1% for economically distressed taxing units).[8] The bills assume that future Legislatures will appropriate replacement funds to locals, without setting clear guidelines about the allocation of those funds, and despite the reality that this expectation is not binding on future legislatures.

The Senate version attempted to address the concerns of local governments by including a provision that is often referred to as a "poison pill"—if in a future year the state did not reimburse local entities in the manner provided in the legislation, the PPT would be reinstated. Interest groups representing businesses and industries were not supportive of the "poison pill," and House leaders have expressed a strong desire to remove it as the legislation is taken up in their chamber. The suggested source of replacement revenues is funds from the phase-out of the credits that are being temporarily honored during the transition from the MBT to the CIT.

***Lieutenant governor's plan:*** The goal of the lieutenant governor's proposal is to provide 100% replacement funding for most local units of government for "essential services," including police, fire and ambulance services. Revenues lost from repealed PPT that fund other "non-essential" services would be reimbursed at 80%, except for local entities whose manufacturing and small taxpayer personal property taxable values are less than 2.5% of their total taxable value for all property (these locals would receive no reimbursement except for their "essential" services).

To assure full funding for police, fire and ambulance services, local governments would have the option of imposing a special "essential services assessment" on the real property of those taxpayers whose PPT had been exempted. However, these taxpayers could opt to continue to pay the PPT if that option was more advantageous than paying the special assessment.

Other PPT losses to entities whose PPT-lost revenues exceed 2.5% of their property tax revenues would be reimbursed through a portion of the current state use tax, which currently goes to the state's General Fund and School Aid Fund. The intent is to reimburse the GF and SAF with funds raised by the phase-out of the credits from the transition from the MBT to the CIT. Expiring tax credits would keep the state from incurring a net revenue loss from the diversion of a portion of the use tax.

To address the concerns of local governments that reimbursements not be subject to the annual legislative appropriations process, Lt. Gov. Calley proposes to create statewide "metropolitan authorities" to distribute replacement PPT funds to local units. The use tax revenues would not be subject to the legislative appropriations process because the metropolitan authority would be the tax levying entity rather than the Legislature. The change in the use tax would require statewide voter approval before taking effect, and local governments are highly skeptical that this complex provision will be easily sold to voters. If the proposal is not approved, then the use tax-derived reimbursements will be subject to annual appropriations.

Diverting use tax revenues to reimburse lost personal property taxes constitutes yet another tax shift from businesses to individuals, as use taxes are expected to be increasingly paid by individuals with the shift to internet sales. If expiring tax credits that are being eyed by policymakers as the revenue stream to hold the state budget harmless from the losses in diverted use taxes are less than the state's use tax losses (which is widely considered to be the case), the resulting budget hole will put more fiscal pressure on state services.

## GIVEN THE CRITICAL NEED FOR FULL REPLACEMENT REVENUES IN THE EVENT OF A PHASE-OUT OF THE PPT, THE CURRENT PROPOSALS ARE FLAWED IN SEVERAL WAYS:

***They will not generate enough revenue for full replacement of PPT losses.*** With the possible exception of police, fire and ambulance services, the lieutenant governor's proposal would reimburse local units for only 80% of revenues lost, and most communities would receive no reimbursement for lost funds other than their essential services. Under the Senate-passed bills, where local units receive reimbursements only if personal property taxes represent less than 2% of their total General Fund revenue, the Senate Fiscal Agency estimates that the majority of local units of government would be unlikely to receive any reimbursement.[9] Without full replacement revenue, local services will be subject to further cuts, or the tax burden will again be shifted to individuals, and particularly low- and moderate-income families and taxpayers.

***Reducing or eliminating the PPT will not make Michigan more competitive if the result is cuts in the local services and infrastructure that attract and retain business investments.*** While the stated goal in reducing or eliminating the PPT is to improve Michigan's business climate and make the state more competitive, tax levels are not the only factor considered by businesses in determining location. It would be counterproductive to reduce funding for the local services that businesses rely on, including public safety and transportation, as well as to weaken the public schools needed to create a skilled workforce, or eliminate the community attractions that draw businesses and skilled workers such as parks and libraries.

## ENDNOTES


1. "Personal Property Tax Phase-Out," S.B. 1065-1072 (S-2): Analysis as Passed by the Senate, Senate Fiscal Agency, August 7, 2012.

2. "Impact of Personal Income Tax Changes Enacted into Law, if Fully Phased-in for Tax Year 2011, All Michiganders, 2011 Income Levels," Institute on Taxation and Economic Policy, May 2011.

3. "Using State Revenues to Incentivize Local Government Behavior," State Budget Notes, Citizens Research Council of Michigan, July 2012.

4. Thomas Ivacko, Debra Horner, and Michael Crawford, "Local Leaders Support Eliminating Michigan's Personal Property Tax if Funds are Replaced, But Distrust State Follow-Through," Michigan Public Policy Survey, The Center for Local, State and Urban Policy, Gerald R. Ford School of Public Policy, University of Michigan, November 2012.

5. David Zin, "The State and Local Impact of Property Taxes Levied on Michigan Personal Property (revised), Senate Fiscal Agency, September 2011.

6. David Zin, "The State and Local Impact of Property Taxes Levied on Michigan Personal Property (revised), Senate Fiscal Agency, September 2011.

7. "Personal Property Tax Phase-Out," S.B. 1065-1072 (S-2): Analysis as Passed by the Senate, Senate Fiscal Agency, August 7, 2012.

8. "economically distressed local taxing units" are defined as those that: (1) have entered into consent agreements or have emergency managers appointed; (2) have projected general fund deficits for the current fiscal year in excess of 5%; (3) have bond ratings that are less than investment grade; (4) have smaller increases or greater declines in taxable valuation than the statewide change in 3 of the preceding 5 years; or (5) are determined to be economically distressed by the Department of Treasury.

9. Personal Property Tax Phase-Out," S.B. 1065-1072 (S-2): Analysis as Passed by the Senate, Senate Fiscal Agency, August 7, 2012.