

Michigan's Economic Future: Challenges and Opportunities

Chapter 6

The Tax System in Michigan

In the words of Supreme Court Justice Oliver Wendell Holmes, Jr., “Taxes are what we pay for civilized society.”¹ On the other hand, nobody enjoys paying taxes, and taxes can damage the workings of the economy. The tension between the benefits of public services and the costs imposed by taxes is at the heart of some of the most important concerns of public economics.

One of the central objectives of tax policy is to choose the *best possible overall level* of taxes. Another objective is to choose the *best possible mix* of income taxes, sales taxes, property taxes, and other revenue sources. These two issues are closely related, and I will discuss both of them in this chapter. I will argue for changes in the overall level of taxes, and I will also argue for changes in the mix of taxes in Michigan.

First, however, let's begin with a brief tour of the tax system in Michigan. When I discuss the tax system, I will usually focus on the *combined* tax systems of the state government and the various local governments. In Michigan (as in most states), local governments and school districts receive a great deal of their funding from the state government. Therefore, it usually makes sense to think of the state tax system and the local tax systems as parts of a whole, rather than as separate entities.

A Brief Overview of the Michigan Tax System

In many ways, the Michigan tax system is similar to the state and local tax systems in most states. Michigan has an individual income tax, as do 43 other states and the District of Columbia.² Michigan also has a general retail sales tax, as do 46 other states and the District of Columbia.³ Every one of the 50 states and D.C. uses property taxes (which are especially important for local governments), as well as taxes on alcoholic beverages, tobacco products, and motor fuels. For more details on the overall structure of the tax system in Michigan, see my chapter, “Overview of Michigan’s Revenue System”, in *Michigan at the Millennium*.

Table 6.1 compares the state and local tax system in Michigan with the average of the state and local tax systems in the United States, for 2002.⁴ The table shows that the percentage composition of Michigan’s state and local tax system is fairly similar to the average composition of the state and local tax systems in the U.S. as a whole. Property taxes account for about 32 percent of tax revenues in Michigan, versus about 31 percent of state and local tax revenues nationwide. The general retail sales tax provides just over 25 percent of the tax revenues in Michigan, and just under 25 percent of the state and local taxes in the United States overall. Individual income taxes account for about 21.5 percent of the tax revenues in Michigan, and about 22.4 percent for the nation as a whole. Thus, if we add together the three main pillars of the state and local tax system (property taxes, general sales taxes, and individual income taxes), we have about 79 percent of tax revenues in Michigan, and about 78 percent of state and local tax revenues nationally.

<Table 6.1 about here>

However, there are some notable differences between the tax system in Michigan and the systems in other states. As seen in Table 6.1, tobacco taxes account for a much larger percentage of tax revenues in Michigan.⁵ The tax system in Michigan also relies relatively heavily on motor-vehicle license taxes. In the next few paragraphs, we will discuss some other unusual aspects of the Michigan tax system.

The Centralization of the Tax System in Michigan

The state and local tax system is more dominated by *state* taxes in Michigan than in most states. In 2002, about 71.3 percent of the state and local taxes in Michigan were collected by the state government. This compares with about 59.1 percent for the nation as a whole. Michigan did not always have such a centralized tax system. However, as a result of the passage of Proposal A in 1994, local property taxes were reduced substantially. Proposal A replaced a portion of the lost revenue with increases in the sales tax and the cigarette tax, both of which are levied by the state government. Proposal A also introduced a new property tax at the state level, known as the “State Education Tax”.⁶ Consequently, control over revenues is heavily concentrated at the state level, so that local governments and public schools have less control over their finances in Michigan than in most other states.

Michigan’s Flat-Rate Income Tax

Another unusual feature of the state and local tax system in Michigan is that the individual income tax has only a single rate. (Currently, the tax rate on all taxable income in Michigan is 3.9 percent.)⁷ By contrast, the individual income taxes in most other states, as well as the federal individual income tax, have “graduated marginal tax rates”. When an income tax

has graduated rates, the tax rate on an additional dollar of income is higher for those with larger incomes. For example, in California, the tax rate on the first dollar of taxable income is one percent. However, California's income tax has six marginal tax rates. The highest of these is 9.3 percent, which takes effect when a married couple has taxable income of slightly more than \$80,000. Thus, when compared to a graduated income tax that raises the same amount of revenue, Michigan's income tax collects relatively more from low-income residents, and relatively less from those with high incomes.⁸

The Single Business Tax

Michigan had a corporation income tax in the late 1960s and early 1970s, but replaced it with the Single Business Tax (SBT) in 1975. The SBT also replaced six other taxes on businesses; hence the name "Single" Business Tax.

James Hines of the University of Michigan discusses the SBT in detail in *Michigan at the Millennium*. The tax base for the SBT consists mainly of the profits of the business, plus employee compensation, depreciation, and interest paid. Forty-five of the 50 states still have a corporation income tax, but no other state has adopted a tax like the SBT.⁹ We will discuss the SBT in much greater detail, later in this chapter.

The Level of Taxes

Figure 6.1 shows some of the trends in the percentage of personal income that goes to state and local taxes. The figure covers the years from 1972 to 2002, which is the most recent year for which comprehensive data are available.¹⁰ Figure 6.1 shows the trends for Michigan

and the U.S. as a whole, as well as for New York (because its taxes are persistently among the highest in the country) and Texas (because its taxes are persistently among the lowest).

<Figure 6.1 about here>

Perhaps the most important trend shown in Figure 6.1 is the significant decrease in the percentage of income that goes to state and local taxes. For the United States as a whole, state and local taxes dropped from about 12.8 percent of income in 1972 to about 10.4 percent in 2002. Michigan's state and local taxes have been fairly close to the U.S. average for most of the last 30 years, especially when viewed against the background of the taxes in states like New York and Texas. However, the decrease in state and local taxes has been even sharper in Michigan than in the rest of the country. In Michigan, state and local taxes fell from about 13.2 percent of income in 1972 to about 10.2 percent of income in 2002. As a result of this substantial decline, taxes in Michigan fell from slightly above the national average in the 1970s and 1980s to slightly below the national average by 2002.

Figure 6.1 is based on the Census of Governments, which is the most comprehensive source of data that can be compared across the states. Unfortunately, complete data are not yet available for the years since 2002. If they were, however, the data would almost certainly reveal a continuation of the trends shown in Figure 6.1. There is every indication that tax revenues in Michigan have continued to shrink, both in absolute terms and relative to the U.S. average. For example, the Department of Management and Budget of the State of Michigan (DMB) provides information on tax revenues for the State government.¹¹ The DMB data indicate that General Fund/General Purpose tax revenues will be about 1.6 percent *less* in 2005-2006 than they had

been in 2002-2003, and this is even before any adjustment for inflation. If we adjust for inflation, the decrease in the real value of these tax revenues is about 10 percent. The DMB calculates that School Aid Fund tax revenues will be about 5.1 percent greater in 2005-2006 than they had been in 2002-2003, but this increase is less than the amount necessary to keep up with inflation.

The drop in tax revenues is the result of several factors. First, there have been explicit cuts in the tax rates for some of the taxes. Second, the tax revenues collected from some sources would have fallen even if there had not been any rate cuts, because of erosion of the tax base. We will discuss the details later in this chapter.

These steep declines in tax revenues are occurring at a time when inflation-adjusted personal income in Michigan has been growing (although, as mentioned in earlier chapters, income growth in Michigan has been slower than the national average). Thus, a smaller and smaller fraction of income is being devoted to the functions of state and local government in Michigan, such as schools, roads, health care, police protection, and fire protection. If Michigan were to return to the relative levels of taxation that prevailed for most of the last generation, the budgets of the state and local governments and public schools would increase by at least \$5 billion per year.

Even as recently as a few years ago, I was cautiously optimistic about the budgetary situation in Michigan. My chapter in *Michigan at the Millennium* does not ring with the same sense of alarm that I would like to convey here. But the fiscal crises of recent years have been a sobering experience. As the resources available for public goods and services have continued to fall, the situation has become more and more dire. When explicit tax cuts are piled on top of a

badly eroded tax base, the result is a tax system that is increasingly out of step with the revenue needs of today and tomorrow.

Unless the trend is reversed, it will be more and more difficult for Michigan to provide the education system and other public services that its citizens deserve. Of course, it is *always* good policy to examine and re-examine the expenditures of government, in search of savings. However, the fiscal crises of recent years have already caused a tremendous amount of belt tightening. Although further economizing must be a *part* of the solution, it cannot be the *entire* solution. If we could provide the public services that are essential for Michigan's future without at least some increases in taxes, I would be the first to say so. In my view, however, it just isn't possible.

I certainly understand that a call for more public revenues is controversial. But I want to make clear that I am not suggesting a radical increase in taxes in Michigan. Instead, I am suggesting a fairly modest reversal of the trends of recent years. The percentage of income that is paid in taxes in Michigan is lower now than it has been in decades. We could have a substantial *increase* in tax revenues, and still be *below* the tax levels of 30 years ago. Thus, I am not calling for tax increases that would take us into uncharted waters. Instead, I am calling for a return to levels of taxation under which Michigan has prospered in the past.

In my view, the main obstacles to improving the tax system in Michigan are political, rather than economic. In an earlier chapter of this book, I related a conversation with a student who suggested it would be "political suicide" to raise taxes. As I said then, if it is political suicide to do what needs to be done for the future of Michigan's economy, then we're dead already.

In the next few pages, I will discuss some specific aspects of the Michigan tax system that have contributed to the decline in tax revenues. Throughout this chapter, the discussion will be framed in terms of the need to collect an adequate amount of revenue. However, it makes no sense to flail about wildly in search of tax revenues. The search must be focused. Thus, some of the tax reforms discussed in this chapter do not involve additional revenues at all. And, when a suggested reform does raise additional revenues, the reform is recommended because it would also advance other goals, such as improving the efficiency or fairness of Michigan's tax system.

Termites in the Tax Base

In some cases, tax revenues can go down as a result of deliberate changes in tax policy. Indeed, policy changes in Michigan have led to revenue reductions on several occasions in the last decade or so. In 1994, Proposal A involved some tax-rate increases, as well as some rate cuts, but the net effect was a decrease in tax revenue. Then, beginning in 1999, the marginal tax rate in the individual income tax was reduced repeatedly, as was the tax rate in the Single Business Tax.¹²

However, tax revenues can also change, even when there is no explicit change in tax policy. For example, when the economy stalled in 2000 and slipped into recession in 2001, tax revenues in Michigan would have fallen, even if there had not been any changes in the tax laws. The downward slide of revenues was exacerbated by the cuts in tax rates.

Now, however, the recession of 2001 is long gone, and yet tax revenues continue to grow sluggishly. Clearly, the business cycle is not the only influence on tax revenues. In fact, the tax system in Michigan has serious structural weaknesses. These weaknesses cause tax revenues to decline year after year, even when the economy is not sinking, and even when there are no tax-

rate cuts. These structural weaknesses are in the sales tax, the income tax, and the taxes on alcohol, tobacco, and motor fuels, and I will discuss each of them in turn.

Erosion of the Sales Tax Base

Joel Slemrod of the University of Michigan provides a detailed discussion of the general retail sales tax in *Michigan at the Millennium*. One of the most important features of the sales tax in most states, including Michigan, is that most services are exempt. Michigan's sales tax does not apply to accounting services, beauty parlors, car washes, carpentry services, dance lessons, dating services, health clubs, laundry and dry-cleaning services, lawn-care services, legal services, movie-theater admissions, pet-grooming services, plumbing services, real-estate-agent services, tanning parlors, tax-return preparation, veterinary services, and a host of other services.

The Federation of Tax Administrators has published information on the taxation of services in 2004, available at <http://www.taxadmin.org/fta/pub/services/services.html>. This report lists 168 service categories. Only Hawaii and New Mexico come close to comprehensive taxation of services. The median state taxes 55 categories. Michigan taxes only 26 of the 168 categories. (Some 38 states and the District of Columbia tax more categories of services than are taxed in Michigan.)

Several of the services that *are* taxed in Michigan are business services. As pointed out in Slemrod's chapter in *Michigan at the Millennium*, an efficient tax system would *not* involve taxes on business-to-business sales. Thus, Michigan's sales tax manages to tax some things that should not be taxed, while failing to tax a large number of items that could be taxed in such a way as to enhance the efficiency of the tax system.

At one time, the non-taxation of services did not make a huge difference, because services were a relatively small part of the economy. But services have grown more rapidly than the rest of the economy for the last couple of generations. As we saw in Chapter 2 of this book, services are now the biggest single part of the economy.

Thus, the revenue losses from non-taxation of services are very large, and they grow larger every year. The Michigan Department of Treasury has estimated the size of the revenue losses in the “Executive Budget: Tax Expenditure Appendix, Fiscal Year 2004”.¹³ (A “tax expenditure” is the number of dollars by which potential tax revenues are decreased, as a result of some provision of the tax code. The estimates are not perfect, because they assume that taxpayers do not change their behavior in response to changes in taxation. However, the estimates are probably a good approximation.)

The Tax Expenditure Appendix lists dozens of holes in the Michigan tax system, totaling about \$27 billion of annual revenue losses. By far the largest of these is the non-taxation of services in the sales tax, which is estimated to have accounted for about \$7.3 billion of lost tax revenues in 2004. This annual revenue loss from not taxing services is almost as large as the amount collected by the sales tax. This points the way toward reform of the tax system. Instead of taxing some things at six percent, and taxing services at zero percent, we could bring more services into the tax base, and raise the same amount of revenue with a tax rate substantially lower than six percent.¹⁴ This has the potential to raise the same number of dollars that we raise now, in a much more efficient manner.¹⁵ In light of the ongoing budgetary crisis, an even more attractive policy would be the following: If the sales tax were extended to a broader range of services, it would be possible to raise *additional* revenue, while still *reducing* the sales-tax rate on the things that are taxed.

In response to proposals to expand the sales tax to cover more services, one sometimes hears the following objection: If we tax a sector of the economy that has previously been untaxed, there will be employment losses in that sector. That may be true (although those who raise the objection have an incentive to overstate the problem, in an attempt to maintain political support for their privileged treatment). However, it is important to keep this in perspective. If tanning parlors have been untaxed in the past, while other things have been taxed, tanning parlors may well have grown more rapidly than they would otherwise have grown. (It is not surprising that activities tend to grow faster when they receive preferential treatment.) Thus, if the privileged tax treatment of tanning parlors were removed, the tanning-parlor sector would probably grow less slowly, and there could be some employment losses there.

However, the situation would be reversed in the sectors of the economy that were previously penalized. Just as the untaxed services have benefited from the unlevel playing field, the taxed activities have been penalized by it. If the playing field were leveled, there might be job losses in the sectors that have previously been privileged, but there would also be job gains in the sectors that have previously been punished. There is no reason to believe that the *overall* level of employment would be harmed substantially.¹⁶

It will not be easy to reform the sales tax in Michigan. Lobbyists will fight hard to maintain the privileged status of each one of the services that currently gets preferential treatment. Nevertheless, if we continue with the current system, which taxes some activities at six percent while other activities get special treatment, the long-run effect will be the continued erosion of the tax base. This will create economic inefficiency, and it will damage our ability to pay for public services in Michigan.

If the states could coordinate their sales-tax policies, it would make for a better tax system nationwide. Michigan is involved in the Streamlined Sales Tax Project (SSTP), which aims to assist the states in administering a simpler and more uniform sales-tax system. For more information on the SSTP, see <http://www.streamlinedsalestax.org>.

Erosion of the Income Tax Base

Paul Menchik of Michigan State University discusses the individual income tax in *Michigan at the Millennium*. In the Michigan individual income tax, the calculation of taxable income begins with adjusted gross income, which is taken directly from the federal tax return. This procedure simplifies the calculation of Michigan income tax, and therefore reduces the taxpayer's cost of complying with the tax laws. However, it also means that many types of income are excluded from the tax base of the Michigan income tax, because they have already been excluded from the federal tax base.¹⁷

The Michigan income tax also includes a personal exemption, which was \$3200 per person in 2005.¹⁸ Additional exemptions are given for senior citizens, individuals with certain disabilities, and children under age 18. Senior citizens are also allowed to deduct Social Security benefits, dividends, interest, capital gains, and pension benefits. After these and a few other adjustments, the taxpayer calculates his or her taxable income. Taxable income is then multiplied by the flat tax rate, which is currently 3.9%. After that, taxpayers may further reduce their tax liabilities if they are able to claim certain tax credits. By far the largest of the tax credits is the Homestead Property Tax Credit, which effectively reduces property-tax liabilities. The Homestead Credit is larger for senior citizens than for the rest of the population.

Because of the various exclusions, deductions, exemptions, and credits, the revenue-raising capacity of the individual income tax is much smaller than it would otherwise be. If the tax base were less eroded, it would be possible to raise more revenue with the same tax rate, or to raise the same amount of revenue with a lower tax rate.

We have seen that senior citizens in Michigan receive a large number of special tax treatments. Seniors receive additional exemptions, and they are able to deduct large amounts of retirement income. Moreover, senior citizens receive extra Homestead credits. Senior citizens receive far more generous treatment from the Michigan income tax than from the income taxes in most other states. As emphasized by Paul Menchik in *Michigan at the Millennium*, the vast majority of senior citizens pay no income tax in Michigan. In fact, the total net amount of income tax paid by Michigan seniors is *negative*. (In other words, their refunds from the Homestead Property Tax Credit are larger than their tax payments.)

As discussed in Chapter 3, Michigan's population is growing older. We can expect an increase in the proportion of the Michigan population who are senior citizens. Therefore, unless the extraordinary generosity of the tax system toward senior citizens is reduced, the revenue-raising capacity of the income tax will continue to shrink.

It is important to address one potential objection to reducing the generosity of the Michigan income tax toward senior citizens. Many elderly people have modest incomes, and it is very reasonable to ask whether these folks should have to pay more taxes. However, it should be remembered that the income tax already addresses this issue through the personal exemption. The reason for the personal exemption is to shield low-income residents from having to pay much income tax. Thus, the low-income elderly have never paid much income tax, and they still

would not pay much income tax if some of the special tax treatments discussed here were removed. Most of the additional taxes would be paid by the affluent elderly.

In my opinion, the interests of the low-income elderly have *not* been a major consideration in Michigan tax policy in recent years. If the plight of the low-income elderly (or other low-income people) were of paramount political importance, Proposal A would not have passed. However, if there is a genuine desire to help the low-income elderly, there are ways to do it without exempting certain categories of income from taxation. For example, we could increase the personal exemption. Most of the benefits of the special provisions go to elderly residents who are not poor, whereas an increase in the personal exemption would benefit all low-income people (and not just the low-income elderly).

I am not under any illusions about the political obstacles to reducing the tax breaks for elderly Michigan residents. Politically, it won't be any easier to reform the income-tax treatment of senior citizens than to tax services, or to reform any other part of the tax system. Nevertheless, if we fail to bring the taxation of seniors more into line with the taxation of the rest of the population, the long-run effect will be the continued erosion of the tax base. This, in turn, will compromise our ability to deal with Michigan's fiscal challenges.

In recent pages, I have emphasized that it has become more difficult to raise revenue, because of the erosion of the sales tax and the erosion of the income tax. But shrinking revenues are not the only result of the non-taxation of services in the sales tax, and the generous tax treatment of senior citizens in the income tax. These tax policies also run counter to basic principles of tax fairness.

The Peculiar Economics of the Taxes on Alcohol, Tobacco, and Motor Fuels

All 50 states have taxes on alcoholic beverages, tobacco products, and motor fuels. Lawrence Martin of Michigan State University discusses Michigan's taxes on alcohol and tobacco in *Michigan at the Millennium*. Kenneth Boyer, also of Michigan State University, discusses the motor-fuels taxes in the volume.

It's important to understand a fundamental difference between these taxes and most other taxes. Income taxes are levied as a *percentage* of taxable income. Property taxes are levied as a *percentage* of the assessed value of the property. Sales taxes are levied as a *percentage* of the price of the item. But most of the taxes on alcoholic beverages, tobacco products, and motor fuels are different. Instead of being levied as a percentage of some dollar value, these taxes are "unit taxes". For example, the tax rates are expressed as a number of cents per gallon of gasoline, or a number of dollars per pack of cigarettes.

For the taxes that are expressed as a percentage of value, an increase in the price of the item leads automatically to an increase in the amount of tax per unit. However, for the "unit taxes", the amount of tax per unit is the same, regardless of the price. This creates two distinct problems. First, when inflation pushes prices higher and higher, the unit tax becomes a smaller and smaller percentage of the total price. Thus, the real revenue-raising capacity of these taxes is eroded over time, unless the legislature increases the tax rate explicitly. In the case of cigarette taxes, this effect has been offset by legislated increases in the tax rate.¹⁹ However, the unit tax on wine has been unchanged since 1981, and the unit tax on beer has stayed the same since 1962. In the four decades since 1962, the overall price level has increased by more than 420 percent.²⁰ As a result, inflation has reduced the effective tax rates substantially, and this has seriously eroded the real revenue-raising capacity of these taxes. Also, the taxes on alcoholic beverages

are probably motivated by a desire to discourage the anti-social behaviors associated with excessive drinking. As the effective tax rate is reduced over time, the disincentive for drinking is also reduced.²¹

The second problem with unit taxes is that they create a strange kind of inequity. The cigarette tax in Michigan is \$2 per pack. If a smoker buys a pack of cigarettes for \$4 per pack, the Michigan tax is one-half of the price. On the other hand, if another smoker buys a premium brand of cigarettes for \$6 per pack, the Michigan tax is only one-third of the price. Thus, the buyers of premium cigarettes pay a lower effective tax rate than the buyers of discount cigarettes. The same thing happens when people buy wine or gasoline: The folks who buy high-priced wines face a lower effective tax rate than those who buy the cheaper varieties, and the folks who buy premium gasoline face a lower effective tax rate than those who buy regular.

There is a clear-cut solution to these problems. We should replace the unit taxes with taxes levied as a percentage of sales price. In that way, inflation would no longer erode the revenues from these taxes over time. And the person who buys regular gasoline won't pay a higher effective tax rate than the one who buys premium. In the case of the cigarette tax, I am in favor of using the percentage tax rate that would raise the same amount of tax revenue as the current unit tax. For the taxes on beer and wine, a strong case can be made for using a percentage tax rate that would raise *more* revenue than is currently raised, to offset some of the erosion of the last few decades.

The taxes on motor fuels are also levied on a per-unit basis. In addition, the tax rate on diesel fuel in Michigan is less than the tax rate on gasoline. This is somewhat unusual. In 2005, 27 states and the District of Columbia imposed the same tax on diesel fuel and gasoline, and 14 states and the federal government imposed a higher tax on diesel. Among the nine states with a

lower tax on diesel fuel, the difference between the gasoline tax rate and the diesel-fuel tax rate is greatest in Michigan. Only five states had a lower excise tax on diesel fuel than Michigan.²² Higher taxes on motor fuels would raise additional revenue, and they may also have environmental advantages. A strong case can be made for (1) raising the tax rates on both gasoline and diesel fuel, (2) raising the diesel tax rate more than the gasoline tax rate, and (3) converting both to a percentage basis.

The Effects of the Michigan Tax System on Different Income Classes

In the case of a “proportional” tax, people with different incomes pay the same percentage of their incomes in tax. If a tax is “progressive”, an increase in income leads to an *increase* in the percentage paid in tax. If a tax is “regressive”, a movement up the income scale leads to a *decrease* in the percentage paid in tax. Thus, a progressive tax takes relatively more from the people with the highest incomes, while a regressive tax takes relatively more from those with the lowest incomes.

As we have seen, the tax system in Michigan has a large number of distinct components. Some of these are progressive, while others are regressive. For a more detailed discussion of these issues, see my chapter in *Michigan at the Millennium*. A brief summary is provided here.

The Distributional Effects of the Individual Income Tax

In Michigan in 2005, the income tax provided an exemption of \$3200 per person. Thus, for a Michigan family of four, the personal exemption would shield $(\$3200)(4) = \$12,800$ from income taxes. The personal exemptions mean that Michigan families who are below the poverty

line pay very little in state income tax. As a result of the exemptions, the individual income tax in Michigan is progressive at low and middle incomes.

However, the Michigan income tax is not as progressive as the income taxes in most other states, because the income tax in Michigan does not have graduated rates. (There are two main ways to generate progressivity in an income tax. Exemptions can create progressivity at the bottom of the income scale, and graduated rates can continue to impart progressivity at higher levels of income. Most states use both of these features, but Michigan only uses exemptions.) As we move up the income scale, the exemptions are a smaller and smaller percentage of income. Therefore, the Michigan income tax becomes less and less progressive when we consider taxpayers with higher incomes. For example, consider a Michigan family of four with income (before exemptions) of \$1,012,800. After the exemptions of \$12,800, this family's taxable income will be exactly \$1 million. Based on a flat income-tax rate of 3.9%, the family will pay \$39,000 in Michigan income tax. When we compare this amount of tax to the family's income (before exemptions), their effective average tax rate is about 3.85%. For another family with twice as much income, the average effective tax rate would be only barely higher, at about 3.88%.

State and local income-tax payments are deductible from the federal individual income tax. This alters the distributional effects of the Michigan income tax for those who itemize deductions on their federal income-tax returns. We will discuss the effects of federal deductibility in a later section of this chapter. In fact, as we shall see, interactions between the Michigan income tax and the federal income tax will eliminate even the tiny amount of progressivity in the high-income ranges that we saw in the preceding paragraph.

The Distributional Effects of Other Taxes

Whereas the income tax is somewhat progressive, at least over a part of the income range, the general retail sales tax is somewhat regressive. This is because the sales tax only applies when people spend their money on taxed goods; *i.e.*, the sales tax does not apply when people save. Since higher-income individuals tend to save more than those with lower incomes, the non-taxation of saving makes the sales tax somewhat regressive. The cigarette tax is also regressive, because smoking is more prevalent among those with lower incomes.²³ On the other hand, the taxes on alcoholic beverages are close to proportional. This is because expenditure on alcohol accounts for about the same percentage of income, throughout the most of the income range.

The state-run lotteries impose an implicit tax on gamblers, because the lotteries return only a fraction of their gross revenues in prizes. In *Michigan at the Millennium*, Lawrence Martin calculates that the implicit tax rate in the Michigan lotteries is about 60 percent, or ten times as high as the tax rate in the general retail sales tax. As we move up the income scale, there is very little increase, if any, in the amount spent on lottery tickets. Therefore, the *percentage* of income devoted to lottery tickets is highest for those with the lowest incomes. As a result, lotteries are the most regressive source of government revenue.²⁴

There is controversy about the effects of property taxes on the distribution of income. If the residential property tax is viewed as a tax on housing, it would be somewhat regressive, because housing accounts for a larger share of income for those with low incomes. If we view the property tax as a tax on capital, it would be somewhat progressive, because high-income taxpayers receive relatively more of their income in the form of capital income, rather than wages and salaries. Each of these views can be used to explain a part of the effect of the

property tax. However, my reading of the literature is that the more important effect of the property tax is as a tax on capital, so that property taxes are a progressive element of the tax system. For a thorough discussion of this and other aspects of property taxation in Michigan, see the chapter by Naomi Feldman, Paul Courant, and Douglas Drake in *Michigan at the Millennium*.²⁵

The Single Business Tax presents special challenges for anyone who would like to determine its effect on different income classes. For one thing, the SBT has a large exemption for small businesses. Thus, the ultimate effects of the SBT depend partly on whether there are differences among consumers of different income classes, in the percentage of purchases that come from small businesses and large businesses. This is a subject about which we have very little information. The distributional effects of the SBT also depend on a number of other factors, such as the degree of competitiveness of labor markets and goods markets. James Hines discusses these issues in *Michigan at the Millennium*.

If we put all of these pieces together, on balance, the tax system in Michigan is probably slightly regressive. A study by Robert McIntyre, *et al.*,²⁶ provides comparisons of the distributional effects of the tax systems in the 50 states. Their results should be treated with caution, because of the difficulty of assigning taxes to different income classes. Still, it is interesting to note that they find Michigan to be one of the ten most regressive states in the U.S.

The Increase in Regressivity Over Time

The tax-policy changes of the last 12 years have made the tax system in Michigan more regressive. As we mentioned above, the income tax is progressive, at least over a large part of the income range, whereas the sales tax is somewhat regressive. In 1994, the income-tax rate

was reduced and the sales-tax rate was increased. Both of these changes would increase the regressivity of the overall tax system. Since 1999, the income-tax rate has been reduced on five more occasions.²⁷ The only substantial tax *increases* of the last few years have been in the regressive tax on cigarettes.

Michigan's tax system has changed in many ways in the last dozen years, so that any concise summary of the changes must be incomplete. However, as I look at the changes, I see one unifying trend: Virtually all of the major changes in the tax law have served to make the tax system more regressive. The persistent theme has been to reduce the taxes on high-income Michigan residents, relative to the taxes on those with lower incomes.

The increase in regressivity is especially troublesome because it has occurred against the background of a widening gap between rich and poor. As mentioned in earlier chapters, the distribution of income has become much more unequal in recent decades. The theory of optimal income taxation shows that taxes should be more progressive when the underlying distribution of income is more unequal,²⁸ but tax policy in Michigan has moved in the opposite direction. At a time when the wages of low- and middle-income workers have been falling, policy makers have chosen to reduce the taxes on the folks at the top, relative to the taxes on the folks at the bottom.

I am not trying to make it sound as if income distribution is the only factor that should have an influence on tax policy. Sound tax policy is based on many considerations, including efficiency and ease of administration, as well as fairness. There are tradeoffs among the various objectives. For example, even though the cigarette tax is regressive, I heartily endorse the recent increases in taxes on cigarettes. Despite its regressivity, the cigarette tax can help to reduce one of the greatest challenges to the health of the American public. Nevertheless, on balance, I believe that the move toward increased regressivity is a step in the wrong direction. I do not

advocate a dramatically progressive tax system, but I do believe that we should reverse the trend toward greater regressivity. In order to reverse the trend, it would make sense for the income tax to play a more important role, since the income tax is progressive over a large range of incomes.

Tax Exporting

“Tax exporting” occurs when the government of one jurisdiction collects tax revenues that are actually paid by residents of a different jurisdiction. For example, an Ohio family will pay some Michigan sales taxes when they take a vacation in Michigan. These sales taxes will go to the State of Michigan, even though Ohio residents actually foot the bill. In this case, we say that Michigan has “exported” some of its taxes to the residents of another state.

Tax exporting can take a variety of forms. In addition to exporting sales taxes through taxes on tourists, some states engage in exporting of income taxes, by levying taxes on out-of-state commuters. However, the largest amounts of tax exporting come from the fact that state and local income taxes and property taxes are deductible from the federal individual income tax. For example, let’s consider a Michigan family who itemize deductions in the federal income tax. For every dollar of income tax or property tax that this family pays to a government in Michigan, they get to reduce their federal taxable income by one dollar. This reduces their federal tax liability. The amount of reduction in federal taxes will depend on their tax rate in the federal income tax. If the Michigan family is in the 25-percent federal tax bracket, their federal taxes are reduced by 25 cents for every dollar of state and local income taxes and property taxes. Governments in Michigan get a dollar, but the net cost to the Michigan taxpayer is only 75 cents.²⁹

The other 25 cents are effectively exported to taxpayers in the entire country. The federal government might respond in any of several ways to the loss of federal tax revenue that occurs as a result of deductions of Michigan taxes. For example, the federal government might raise other taxes. If so, however, those additional taxes would be paid by people all across the country, and not just by Michigan residents. Alternatively, the federal government might cut services. Once again, however, those cuts would be felt throughout the United States, and not just in Michigan. Finally, the federal government might go further into debt. This would impose a burden on future generations of taxpayers in all 50 states, and not just in Michigan. Thus, although the details will differ depending on the federal government's policies, deductibility means that some Michigan taxes are shifted from Michigan residents to the residents of other states.

Until 1986, the federal individual income tax offered a deduction for state and local income taxes, property taxes, and sales taxes. However, the deduction for state and local sales taxes was removed by the federal Tax Reform Act of 1986.³⁰ This gave states an incentive to *decrease* their reliance on sales taxes, since sales taxes were no longer deductible. And it also gave states an incentive to *increase* their reliance on income taxes and property taxes, since these taxes were (and still are) deductible. In fact, however, Michigan has done exactly the opposite. When Proposal A was passed in 1994, Michigan lowered its property-tax rates (even though property taxes were still deductible) and greatly increased its sales-tax rate from four percent to six percent (even though sales taxes were no longer deductible). At the same time, the Michigan income-tax rate was decreased (even though income taxes were still deductible). The income-tax rate has been reduced five more times since Proposal A.

By decreasing income taxes and property taxes, and increasing sales taxes, Michigan is “leaving money on the table”. It would be possible for Michigan governments to raise the same

amount of tax revenue in Michigan, while sending fewer dollars to the federal government in Washington. But we have chosen not to do so.

The amount of money left on the table is very substantial. According to an estimate by the Office of Revenue and Tax Analysis, Michigan residents paid about \$900 million more in federal taxes in 2003 than they would have paid if Proposal A had not been enacted.³¹

Why the Decline in Tax Exporting?

On the basis of the analysis in the last few paragraphs, it is reasonable to ask why some states, including Michigan, have been so reluctant to take advantage of tax exporting. Many explanations are possible. (For a discussion, see Joel Slemrod's chapter in *Michigan at the Millennium*.) One possibility is that the issue of tax exporting has simply been under the radar screen of the public discussion. It certainly appears that tax exporting has played only a very minor role in tax-policy debates in Michigan. Another possibility is that the lack of tax exporting is closely connected to the increased regressivity of the tax system. Those who desire a more regressive tax system have achieved greater political power in the last few decades, and they are willing to leave money on the table, if that is what it takes to achieve the goal of greater regressivity. Thus, the amount of money left on the table provides us with a measure of the intensity of the desire to shift more of the tax burden onto the shoulders of low-income residents.

I do not want to overstate the case for tax exporting. It is certainly *not* clear that tax exporting through deductibility is a good policy for the nation as a whole. On the other hand, if the federal government offers Michigan governments the opportunity to export their taxes through deductibility, it is curious that they refuse to take greater advantage of the subsidy.

Tax Exporting and the Rate Structure of Michigan's Income Tax

We have discussed the large increase in income inequality over the last 30 years, and we have also discussed the chronic fiscal crises of governments in Michigan. An increase in Michigan's individual income tax would address both of these problems. An increase in the income tax would raise revenue for cash-strapped governments in Michigan, and it would also reduce the recent trend toward increasing the taxes of low-income Michigan residents.

Because state and local income taxes are deductible from the federal income tax, a major portion of any increase in Michigan's income tax would be exported. In other words, if we were to increase the Michigan income tax, much of the additional revenue would actually come from residents of other states.

However, income-tax revenues in Michigan can be increased in a variety of ways, and the different methods have very different implications for tax exporting. This is because tax exporting takes place through deductibility in the federal income tax, and only about one-third of taxpayers itemize deductions on their federal tax returns. Most itemizers have relatively high incomes. Therefore, if Michigan's income tax were increased, the amount of additional tax exporting would be greater if relatively more of the increase were applied to high-income residents of Michigan. The most effective way to do this would be to introduce graduated rates. (This would require an amendment to the Michigan Constitution. Therefore, in political terms, it may be even more difficult to introduce graduated rates than it would be to make some other tax-policy changes. But tax reform is never easy.) My preference is to keep things simple by introducing only one higher tax bracket, although it would be possible to introduce several additional brackets, as some states have done.

Before concluding this section, I must re-emphasize the fact that tax exporting through federal deductibility is only one consideration in the design of Michigan tax policy. Even if state and local income taxes were not deductible, I would still make the case for greater progressivity in the Michigan income tax, because of my concern about the widening gap between rich and poor. However, in my view, the case for a second marginal tax rate in the Michigan income tax is strengthened by tax exporting through federal deductibility.³²

The Single Business Tax

Michigan had a corporation income tax from 1968 to 1975. During those years, the state experienced huge fluctuations in corporate tax-revenue collections. Tax revenues from the Michigan corporate tax fell by about 40 percent between 1969 and 1971. Then, corporate tax revenues doubled between 1971 and 1973, as the economy recovered from the mild recession of the early 1970s. But another recession came, and revenues fell by more than 40 percent between 1973 and 1975. Thus, the corporate tax sent Michigan's fiscal system on a nauseating roller-coaster ride. This is not surprising, since corporate profits have bigger up-and-down swings than other types of income.

Large revenue fluctuations can create major problems for planning and delivering public services. One reason for switching to the Single Business Tax was a desire to get off the revenue roller coaster. In that regard, the SBT has definitely been a success. As shown in James Hines's chapter of *Michigan at the Millennium*, SBT revenues do not soar and dive with the business cycle. Thus, as Hines puts it, the SBT provides "...important revenue cushions in years in which the state government has most needed revenues. Other states have found their corporate tax

collections moving with the business cycle, thereby exacerbating revenue shortfalls in recession years.”

Although revenue stability is an attractive feature, it is not the only consideration in setting tax policy. In some other respects, the SBT does not perform as well. For example, under a tax like the SBT, there will be problems in dealing with the capital investments of firms that do business in many states. Policymakers in Michigan would like to stimulate investments in Michigan, while avoiding subsidies for capital investments in other states. In an attempt to balance these considerations, Michigan adopted a formula for apportioning business deductions for investment in personal property. (Personal property consists primarily of business equipment.) Originally, multi-state companies could take an SBT deduction for a percentage of their total U.S. expenditures on business equipment, where the percentage was determined by the share of U.S. employment and U.S. business property located in Michigan. However, this system was challenged in court. Over time, the tax treatment of business investments in the SBT has been changed repeatedly, although it is not clear that a fully satisfactory solution can be found. (For a description of the complicated history of SBT deductions for business investment, see Hines’s chapter in *Michigan at the Millennium*. Also, note that the difficulties in establishing rules for investments by multi-state firms are not confined to the SBT. The same problems are encountered in the corporate taxes that are used in most other states.)

The SBT has been changed in many other ways over the years. In response to a variety of political pressures, lawmakers have approved a dizzying array of exemptions, deductions, and credits. Some of these changes have made the SBT more complex, more difficult to understand, and more inefficient. In 1999, the legislature decided to phase out the SBT, over a period extending to 2020. In 2002, the expiration date for the SBT was moved up to 2009. Since then,

the SBT has continued to be the subject of political wrangling. As of this writing, an attempt is being made to place a proposal on the ballot, under which Michigan voters would eliminate the SBT.

Some of the problems of the SBT have more to do with perceptions than with realities. For example, one sometimes hears the objection that the SBT places a heavy burden on small businesses, but this is simply untrue. The SBT contains a very generous exemption for small businesses, so that the overwhelming majority of SBT revenues are paid by large enterprises.

One reason that the SBT may discourage businesses from locating in Michigan is that no other state imposes an SBT. Thus, it is possible that the costs of complying with the tax would keep businesses away from Michigan. In fact, the compliance cost of the SBT is probably no greater than the compliance costs of the corporate taxes that are imposed in most other states. On the other hand, sometimes perception *is* reality. If businesses *believe* that the cost of complying with the SBT is high, they may avoid doing business in Michigan, even if the *actual* compliance costs are not unusually high.

Nevertheless, it is important to avoid overstating the problems of the SBT. The detractors of the SBT sometimes make exaggerated claims about the economic disincentives caused by the tax. It is true that the SBT (like any other tax) distorts economic decisions. However, even though business taxes are important, they are only one part of the economic picture. The SBT is not the main cause of Michigan's economic problems, and Michigan will not suddenly become an economic paradise if the SBT is eliminated. The relative decline of manufacturing is a nationwide phenomenon, and it was already well underway before the SBT was even introduced. As shown in Chapter 3 of this book, Michigan's population lags behind the national average in terms of educational attainment, and the lack of education cannot be

blamed on the SBT. If the SBT had never existed, Michigan's economy would not be dramatically different from the way it is today.

Policy Options for the Single Business Tax

Clearly, the Single Business Tax has some advantages and some disadvantages. Anyone who reads James Hines's chapter in *Michigan at the Millennium* will see that a good case can be made for keeping the SBT. However, based on my assessment of the relative importance of these advantages and disadvantages, I believe the best option is to eliminate the SBT. If this were done, it would be a powerful signal of Michigan's desire for a favorable business climate. No other tax-policy initiative has as much potential to improve Michigan's reputation as a haven for capital investment.³³

However, if the SBT is eliminated, *it is crucially important to replace the revenues.* If we were to eliminate the SBT and *not* replace it with any other source of revenue, an extra shortfall of nearly \$2 billion per year would be added to the budget of the State of Michigan, at a time when the state is already experiencing chronic budget crises. This would be fiscally irresponsible in the extreme. *If the legislature is unwilling to replace the revenue, then the SBT should be kept in place,* and we should focus on getting the SBT to work as smoothly as possible.

Some people argue that the SBT should be replaced by a corporate income tax, because Michigan "must" have a business tax. But this is not a very sensible argument. There simply is not any rule that a state has to have some sort of business tax. Some of the political support for business taxes is based on the misguided impression that businesses are somehow separate from the rest of the economy, and that businesses should pay their "fair share" of taxes. But it really isn't meaningful to speak of "business's share" of taxes. Ultimately, taxes are borne by people,

in the form of lower wages for workers, or higher prices for consumers, or lower returns on investment for the owners of capital. Also, as we have seen, corporate tax revenues tend to rise and fall dramatically over the business cycle. Therefore, a corporate tax in Michigan can be expected to produce a volatile stream of revenues. This would make it all the more difficult to carry out sensible budget policies. Moreover, a corporate tax is likely to impose greater efficiency costs than the SBT. *If the only replacement tax acceptable to the legislature is a corporate income tax, then the SBT should be retained.*

If my suggestion is followed, we will eliminate the Single Business Tax, and replace the revenues with something other than a corporate tax. There are plenty of attractive candidates for the source of the revenues to replace the SBT. The two most important of these are:

- Adding a second rate to the individual income tax; and
- Increasing the taxation of services in the sales tax.

Beyond those two possibilities, a number of other potential revenue sources are available. These include plugging some of the holes in the individual income tax; and increasing the tax levels on alcoholic beverages.³⁴

In summary, I list the four main options for the Single Business Tax, in order of my assessment of their desirability:

1. Eliminate the SBT, and replace the revenues with something other than a corporate tax, such as an extension of the income tax or the sales tax.
2. Keep the SBT, and strengthen it by removing some of the special deductions, exemptions, and credits that have crept in over the years. This is not a bad option, and it is definitely the best option if #1 is politically infeasible.
3. Replace the SBT with a corporate tax. (This is a bad idea.)

4. Eliminate the SBT, and don't replace it with anything. (This is a *really* bad idea.)

In current policy discussions in Michigan, one sometimes hears the idea of increasing the sales tax to replace not only the SBT but also the income tax. This is also a very bad idea. Its most important effects would be to shift even more taxes away from those with highest incomes, and to increase the taxes paid by those at the bottom of the income scale.

Property Taxes

Prior to the enactment of Proposal A in 1994, property taxes in Michigan were based on the "state equalized value" (SEV), which is equal to one-half of the true value of the property. Proposal A instituted the requirement that the taxable value of a property cannot increase in any one year by more than five percent or the rate of inflation, whichever is less. Thus, even when the *true* value of a property increases by eight percent in a year, the *taxable* value cannot increase by more than five percent, and the taxable value may increase by only a few percent when the overall rate of inflation is low. However, when the property is sold, the taxable value reverts to the SEV, and the limitation on the increase of taxable value begins anew.

This "cap" on taxable value is associated with three important problems. First, the cap reduces the revenue-raising capacity of the property tax, at a time when governments in Michigan are subject to chronic fiscal crises. Second, there is an issue of simple fairness. The cap means that two properties can have very different property-tax liabilities, even if the true value of each of them is exactly the same. For example, I have lived in the same house since before Proposal A, and the taxable value of my home is now well below its SEV. But some of my neighbors have only recently moved into the neighborhood. The taxable values of their homes were put back in line with SEV when the homes were sold. Thus, I pay less in tax than

some of my neighbors, even though the true value of my home is the same as the true value of theirs. Of course, I reap a benefit from this (as long as I stay put). It is easy to understand the political appeal of a provision like this: Long-time residents tend to have more political power than those who have recently moved into a community. But the policy is still unfair.

The third problem with the cap on taxable value has to do with economic efficiency. Because of the cap, the effective tax rate on some properties is lower than the effective tax rate on others. It would be more efficient to tax all properties at the same effective rate.

On the basis of all of these issues, my conclusion is that the cap on property-tax assessments should be phased out.

In this chapter, we have devoted a great deal of discussion to Proposal A. However, Proposal A was not the first landmark change in property taxation in Michigan in the last few decades. The first was the “Headlee Amendment” of 1978. Whereas the assessment cap in Proposal A limits the taxes on *individual properties*, the Headlee Amendment limits the amount of property-tax revenue that can be raised by *jurisdictions*. If the total assessed value of property in a unit of local government increases faster than the Consumer Price Index, there can be an automatic reduction in the property-tax millage rate. This type of tax-rate reduction is known as a “Headlee Rollback”.

In the period of nearly 30 years since the passage of the Headlee Amendment, a large number of Headlee Rollbacks have occurred. However, under certain circumstances, a community can avoid being constrained by the Headlee limitations. For example, new construction is excluded from the Headlee calculations. Thus, all else equal, it will be easier for a rapidly growing community to avoid a Headlee Rollback, than it would be for a community that is not experiencing much growth. Also, if a community is levying a property-tax millage

rate that is less than the maximum allowable rate in a given year, the community has the option of increasing total expenditures beyond the rate of inflation in the following year.

In a recent study, Elisabeth Gerber and Michelle Woolery of the University of Michigan look at the factors determining whether communities are at the maximum allowable property-tax rate.³⁵ Using data for 87 cities in southeastern Michigan, they find that communities with greater property wealth are much less likely to be constrained by the Headlee limitations, all else equal. Their study suggests that, in communities where the median home value is greater than \$200,000, the probability of being at the maximum allowable property-tax rate is close to zero. On the other hand, the probability of being at the maximum is about 70 percent for communities with median home value of less than \$100,000. Thus, to a major extent, the Headlee limitations perpetuate the inequalities in tax and spending levels that existed in 1978.

The Headlee limitations can interact with the provisions of Proposal A in complicated ways. For a more complete discussion of these interactions, as well as many other aspects of property taxation in Michigan, see the chapter in *Michigan at the Millennium* by Naomi Feldman, Paul Courant, and Douglas Drake.

Summary and Conclusion

In this chapter, I have described the tax systems of state and local governments in Michigan. In several respects, these tax systems are very much like their counterparts in most other states. As in most states, the revenue system is dominated by property taxes, individual income taxes, and general retail sales taxes. In some other respects, however, Michigan's tax system is unusual. When compared with the national average, the *state* government in Michigan collects a substantially higher fraction of the total revenues, while the *local* governments collect

less. Michigan's individual income tax is unusual, in that it applies a single flat rate to all taxable income, instead of using a system of graduated marginal tax rates. Also, Michigan's Single Business Tax is unique among the 50 states.

The level of taxation in Michigan has fallen over the last few decades, and the decreases have been especially rapid in the last five years. Until recently, the percentage of personal income paid in taxes was slightly higher in Michigan than the national average. However, this is no longer true. In 2002, which is the most recent year for which we have comprehensive data that can be compared among the states, state and local tax revenues in Michigan were slightly below the national average (even though the national average dropped substantially since the 1970s). Inflation-adjusted tax revenues have continued to fall in the last three years. Some of the reductions in tax revenues have been the result of explicit policy changes: Over the last 12 years, tax rates have been reduced in the property tax, the individual income tax, and the Single Business Tax. However, some of the tax-revenue reductions have resulted from structural weaknesses in the tax system. For example, the sales tax does not apply to most services. Over time, services have accounted for a larger and larger fraction of the economy, so that the revenue losses from non-taxation of services continue to increase.

As mentioned earlier in this chapter, Michigan's tax system is one of the most regressive in the country, which means that a relatively large share of taxes in Michigan is borne by low-income residents. Moreover, the Michigan tax system has become more regressive over time: Individual income taxes have been reduced, while the regressive sales tax has been increased.

Michigan has increased its reliance on the sales tax, even though sales taxes are not deductible from the federal individual income tax. On the other hand, Michigan has reduced its income and property taxes, even though these taxes are deductible. This means that Michigan

has reduced the extent to which it “exports” its taxes to the residents of other states. In fact, taxpayers in Michigan pay hundreds of millions of extra federal taxes every year, as a result of the shift from deductible taxes to non-deductible taxes.

Any change in tax policy will face major political obstacles. Nevertheless, it is imperative to think anew about taxes in Michigan. The current tax system has serious structural problems, which we ignore at our peril. If nothing is done to address these problems, the Michigan tax system will become more inefficient, and it will become increasingly unable to finance an appropriate level of public services. Thus, based on the analysis in this chapter, I have identified a number of tax-policy changes that deserve very serious consideration. The first and foremost need is to reverse the steady decline of tax revenues in Michigan. It makes the most sense to do this in ways that also help to achieve other objectives for the tax system, such as economic efficiency and fairness. The following proposals would raise revenue, while also improving the tax system in other ways:

- ***Taxing services.*** The general retail sales tax in Michigan applies to a few services, but a great deal of the service economy is untaxed, even though services have been steadily increasing in relative importance for decades. If more services are taxed, the revenue-raising capability of the tax system will be reinforced. Just as important, more complete taxation of services will make the sales tax more efficient and more equitable.

- ***Adding a second tax bracket in the individual income tax.*** Michigan is one of only a few states that have an income tax with only a single tax rate. Of the 43 states with an income tax, 37 have a system of graduated marginal tax rates, with higher rates on those with higher incomes. A second tax rate would raise additional revenue, and it would also go against the recent trend of putting more of the tax burden on the shoulders of the low-income residents of

Michigan. In addition, some of the additional income-tax revenues would actually be borne by the residents of other states, as a result of the deductibility of state and local income taxes in the federal income tax.

- ***Reducing the tax preferences for the elderly in the income tax.*** The individual income tax in Michigan provides extraordinary tax breaks for elderly residents. As a result, very few senior citizens in Michigan pay any income tax. On net, Michigan seniors actually pay *negative* amounts of income tax. The revenue losses associated with these tax breaks are expected to grow substantially as the Baby Boom generation enters retirement. If the taxation of senior citizens were brought more into line with the patterns of taxation in other states, it would help to preserve the integrity of the tax system.

- ***Changing the taxation of alcoholic beverages, tobacco products, and motor fuels.*** Currently, these taxes are levied on a *per-unit* basis. When taxes operate in this manner, their revenue-raising capacity is eroded over time by inflation. The unit taxes on beer and wine in Michigan have remained the same for decades, even though inflation has pushed prices dramatically higher. Therefore, the effective tax rates on beer and wine have decreased greatly. If these tax rates were raised, and then converted to a percentage basis, it would help to shore up the revenue system, and it would also help to discourage irresponsible drinking. It would also be a good idea to convert the taxes on tobacco products and motor fuels to a percentage basis. Moreover, Michigan is unusual in that the tax on diesel fuel is lower than the gasoline tax. An increase in the tax rate on diesel fuel would raise additional revenue at the same time that it eliminates the inequitable treatment of drivers of different vehicle types.

- ***Removing the “assessment cap” in the property tax.*** Since the passage of Proposal A, the *taxable* value of any individual property cannot increase in one year by more than the overall

rate of inflation, or five percent, whichever is less (even if the *market* value of the property increases by more). However, properties are reassessed at full value when sold. As a result, two adjacent properties can have very different property-tax bills, even if they have exactly the same market value. If the assessment cap were removed, this inequity would be removed along with it, and additional revenue would be raised. If there is a desire to avoid a sudden spike in property taxes, the elimination of the cap could be accompanied by an overall reduction in property-tax rates. However, such a rate reduction should not be too large, or it would merely exacerbate the budgetary problems.

Finally, policy makers in Michigan must decide what to do with the Single Business Tax. There is little doubt that the SBT is an improvement upon the corporation income tax, which it replaced in 1975. Nevertheless, the SBT has encountered a number of problems, especially in the tax treatment of business investments. Over the years, the SBT has become riddled with deductions and exemptions. Currently, the SBT is a few years away from scheduled elimination.

In my judgment, the best policy would be to eliminate the SBT. However, if the SBT is to be eliminated, it must be replaced with *something*. To eliminate the SBT and *not* replace it would be fiscally irresponsible to an astonishing degree. If the legislature is unwilling to replace the lost revenues, then the SBT should be kept in place. Moreover, we cannot replace the SBT with just anything. If the SBT is removed and replaced, it should *not* be replaced with a corporation income tax. The best sources of revenues to replace the Single Business Tax are the individual income tax and the general retail sales tax.

Table 6.1
Revenues for Selected Taxes, as Percentage of Total Tax Revenues,
For Michigan and the United States, 2002

<u>Tax</u>	As Percent of State & Local Taxes <u>In Michigan</u>	As Percent of State & Local Taxes <u>In the United States</u>
Property Taxes	31.96%	30.84%
General Retail Sales Taxes	25.40	24.64
Individual Income Taxes	21.53	22.42
Motor Fuel Taxes	3.56	3.65
Motor Vehicle License Taxes	2.91	1.87
Tobacco Taxes	2.19	1.00

Source: Author's calculations based on U.S. Census Bureau, State and Local Government Finances, 2002 Census of Governments. Available at <http://www.census.gov/govs/www/estimate02.html>.

Endnotes for Chapter 6

¹ *Compañía de Tabacos v. Collector*, 275 U.S. 87, 100 [1904].

² The states with no income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

³ Delaware, Montana, New Hampshire, and Oregon have no retail sales taxes.

⁴ Table 6.1 is based on information from the Census of Governments for 2002. This is the most recent year for which we have comprehensive data on state and local finances for each of the 50 states. Later in this chapter, I will provide a few comments on the changes in the intervening years.

⁵ In fact, the numbers in Table 6.1 understate the difference between tobacco taxes in Michigan and tobacco taxes in other states, because these data were collected before the cigarette tax in Michigan was raised to \$2 per pack in 2004. As of January 1, 2005, the cigarette-tax rate in Michigan was third-highest in the country, behind the rates of \$2.46 per pack in Rhode Island and \$2.40 per pack in New Jersey. (These data are from the Federation of Tax Administrators, at <http://www.taxadmin.org/fta/rate/cigarett.html>.) This contrasts with rates of less than 10 cents per pack in Kentucky, North Carolina, and South Carolina.

⁶ In 1992, about 3.7 percent of the property taxes in Michigan were collected by the state government. By 2002, state property taxes accounted for about 19.3 percent of the property taxes collected in Michigan.

⁷ In addition to Michigan, five other states have a flat-rate income tax. These are Colorado, Illinois, Indiana, Massachusetts, and Pennsylvania. Details on the income-tax rates in the various states are available at http://www.taxadmin.org/fta/rate/ind_inc.html.

⁸ The personal exemptions in the individual income tax also have an effect on the distribution of the tax burden among people of different income classes. As of January 1, 2005, some 31 states used a personal exemption. The personal exemption for a married couple is larger in Michigan than in 19 of these states, and smaller than in 11 of them. Seven states use a credit in lieu of a personal exemption. The effective dollar value of these credits is larger than the personal exemption in Michigan in some cases, and smaller in others.

⁹ In addition to Michigan, the states without a corporation income tax are Nevada, Texas, Washington, and Wyoming.

¹⁰ For all of the years from 1992 to 2000, as well as for 2002, annual data are available at the Census Bureau web site, at <http://www.census.gov/govs/www/estimate.html>. For 1972, 1977, 1982, and 1987, the data are taken from the Census of Governments, vol. 4, no. 5, "Compendium of Government Finances". In constructing Figure 6.1, the years between 1972 and 1977, 1977 and 1982, 1982 and 1987, 1987 and 1992, and 2000 and 2002 were interpolated. For more on

calculations of this type, see my report “Michigan’s Tax Climate: A Closer Look”, prepared for the Michigan Chamber Foundation, April, 2004.

¹¹ See “Executive Budget, Fiscal Year 2006”, available at http://www.michigan.gov/documents/FY05Document1_84532_7.pdf. These data are for state taxes only, while the Census data are for both state and local taxes, so the two are not strictly comparable. Nevertheless, the revenue trends for the State of Michigan are highly indicative, since the state government collects substantially more than the local governments in Michigan.

¹² When tax rates are reduced, there will usually be an increase in economic activity, all else equal. Thus, all else equal, a reduction in tax rates will usually lead to an increase in the tax base. This means that the decrease in tax *revenues* will be relatively smaller than the decrease in tax *rates*. However, the increase in economic activity will not usually be large enough to lead to an increase in tax revenues.

¹³ See http://www.michigan.gov/documents/ExFY2004_59269_7.pdf.

¹⁴ For a very readable discussion of the possibility of taxing more services, along with commentary from several current and former public officials, see the article by Stacey Range and Chris Andrews in the *Lansing State Journal*, October 16, 2005.

¹⁵ The tax rate that would raise the same amount of revenue would depend on how many items were brought into the tax base. However, as mentioned above, an efficient tax system would not

involve taxes on business-to-business sales. Thus, if a tax reform is to be carried out in the best way, it cannot merely tax everything in sight.

¹⁶ To further reinforce my point about job losses, I offer this analogy: Suppose that people with family names beginning with the letter “B” were exempt from paying the income tax and the payroll tax. This would obviously be a huge advantage for people like me, but that does not make it good tax policy. It would be both inequitable and inefficient. If it were then proposed to eliminate the privileged treatment of the B’s, it is easy to imagine B’s arguing that the reform would reduce employment of B’s. In fact, it is very possible that B employment would be reduced by the reform, but that is not the end of the story. Employment of folks with names beginning with other letters would likely increase, because they would no longer be penalized by the tax system. In fact, overall employment might increase, because the reformed tax system would allow for a more efficient allocation of resources in the economy.

¹⁷ The largest items excluded from the tax base are the employer contributions for health insurance and pensions.

¹⁸ As pointed out by Paul Menchik in *Michigan at the Millennium*, the inflation-adjusted value of the personal exemption is now only about half as large as it was when the Michigan income tax was established in the late 1960s.

¹⁹ The tax on cigarettes in Michigan was raised from 75 cents per pack to \$1.25 per pack in 2002, and then to \$2.00 per pack in 2004.

²⁰ This calculation is based on the Implicit Price Deflator for Personal Consumption Expenditures, available from Table 1.1.4, from the web site of the Bureau of Economic Analysis, U.S. Department of Commerce, at <http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N>. If we use the Consumer Price Index, the increase of the price level from 1962 to 2005 is even steeper, at about 550 percent. For technical reasons, I prefer to use the Personal Consumption Expenditures deflator. However, either of these inflation measures makes it clear that the price level has risen a great deal in the last 40-plus years.

²¹ Of course, taxes on alcoholic beverages are a fairly blunt method for discouraging excessive drinking, since the tax on the casual drinker is levied at the same rate as the tax on the binge drinker. It's important to enforce the drunk-driving laws, regardless of the tax rate on alcoholic beverages. There is evidence that the optimal fine for a drunk-driving arrest should be very high. (See Steven Levitt and Jack Porter, "How Dangerous are Drinking Drivers?", *Journal of Political Economy*, 2001.)

²² These data are from the web site of the Federation of Tax Administrators, at http://www.taxadmin.org/fta/rate/motor_fl.html.

²³ See Lawrence Martin's chapter in *Michigan at the Millennium*, for an extensive discussion of the effects of the cigarette tax on the distribution of income. The economist Jonathan Gruber has advanced a novel argument, suggesting that the cigarette tax is not regressive, but Gruber's

perspective is still controversial. In this discussion, I will maintain the traditional view that cigarette taxes are regressive.

²⁴ See Lawrence Martin's chapter in *Michigan at the Millennium*. Charles Clotfelter and Philip Cook provide an overview of the economic issues associated with lotteries in "On the Economics of State Lotteries" (*Journal of Economic Perspectives*, 1990).

²⁵ Paul Courant is with the University of Michigan. Douglas Drake was with Wayne State University when *Michigan at the Millennium* was written, but he is now with Public Policy Associates. Naomi Feldman was with the University of Michigan when *Michigan at the Millennium* was written; she is now at Ben-Gurion University of the Negev.

²⁶ Robert McIntyre, Robert Denk, Norton Francis, Matthew Gardner, Will Gomaa, Fiona Hsu, and Richard Sims, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States" (2nd edition), Institute on Taxation and Economic Policy (2003).

²⁷ A reduction in the tax rate is not the only way to reduce the revenues from the income tax. Another possibility would be to increase the personal exemption. These two methods of tax reduction have different effects on the distribution of income. An increase in the exemption would be relatively more favorable for low- and middle-income families, whereas rate reductions are relatively better for those with higher incomes. Since the recent income-tax changes have focused on rate reductions, rather than on increases in the personal exemption, they are consistent with the overall trend toward regressivity.

²⁸ For example, see Nicholas Stern, “On the Specification of Models of Optimum Income Taxation” (*Journal of Public Economics*, 1976).

²⁹ Earlier in this chapter, we discussed the effect of the Michigan income tax on the distribution of income. The income tax is somewhat progressive at low incomes, because of the personal exemptions. For middle incomes, the tax is approximately proportional, because it has only a single flat rate. However, because of deductibility, the net effect of the Michigan income tax is actually somewhat regressive at high incomes. For example, consider a married couple with \$60,000 of federal taxable income in 2004. This family would have been in the 25-percent federal tax bracket. When the couple paid a dollar of Michigan income tax, they would save 25 cents of federal tax, so that their net payment would be 75 cents. On the other hand, a couple with \$320,000 of federal taxable would have been in the 35-percent federal bracket. When this couple paid a dollar of Michigan income tax, their net payment would be only 65 cents. One other complication bears noting. The federal income tax includes an “Alternative Minimum Tax” (AMT). When it was instituted in 1969, the AMT was targeted at a very small number of taxpayers with very high incomes, who had taken advantage of special provisions of the tax code to avoid paying any federal income tax. However, the AMT is not adjusted for inflation, and the AMT rules have not been adjusted to keep pace with other tax-policy changes. Hence, unless the law is changed, the number of taxpayers affected by the AMT is expected to skyrocket in the next few years. The AMT is relevant to tax exporting because AMT liability can be triggered by deductions for state and local taxes. If the deductions cause “too much” of a reduction in a taxpayer’s regular federal income-tax liability, the taxpayer may have to pay AMT. Thus, one

effect of the AMT is to create a back-door method of reducing the effect of the deduction for state and local taxes. If the AMT is not changed, it could significantly reduce the extent of tax exporting through federal deductibility. However, it is possible that the AMT may be reduced or eliminated. President Bush's Advisory Panel on Tax Reform has recommended abolition of the AMT (although it remains to be seen whether this recommendation will be enacted).

³⁰ Recently, the deduction for state and local sales taxes was partly reinstated. Taxpayers can now deduct either their state and local income taxes, or their sales taxes, but not both. As a practical matter, this will have very little effect on Michigan taxpayers. Its greatest effect will be for taxpayers in states like Florida and Texas, which do not have an income tax.

³¹ See "School Finance Reform in Michigan: Proposal A: Retrospective", available at http://www.michigan.gov/documents/propa_3172_7.pdf.

³² President Bush's Advisory Panel on Tax Reform has proposed to eliminate the deductions for state and local taxes. (See Robert Guy Matthews, "Tax-Overhaul Panel Gives Bush Two Choices", *Wall Street Journal*, October 19, 2005.) However, the fate of this proposal is uncertain. The political obstacles to federal tax reform are well known, and many analysts have expressed doubt that the Panel's recommendations will be adopted soon.

³³ Of course, if the SBT were eliminated, it would no longer be possible to offer SBT abatements for particular proposed investments. On balance, however, there are many advantages to having

no SBT, rather than having an SBT with more special provisions. Also, SBT abatements are not the only way to try to attract businesses.

³⁴ The taxes mentioned in this section provide revenue for the state government, rather than local governments. However, it would certainly be possible to arrange for some portion of the revenues to go directly to local governments.

³⁵ See Elisabeth Gerber and Michelle Woolery, “Federalism and Equality: The Impact of State Fiscal Policies on Local Governments” (Working Paper, University of Michigan, November 2005).