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Public Sector Reports

Michigan **COMMENTARY**

Reforming the Michigan Tax System

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It is becoming clearer each year that a large portion of Michigan's continuing budget problems can be traced to an inadequate state revenue system. Combine this with slow economic growth and an unwillingness to raise taxes and you have a recipe for disaster.

Controlling expenditures is justified any time, particularly during a period of slow economic growth, but we must recognize that the problem is not all on the expenditure side. If this state continues to ignore the revenue side of the equation, it will not be long before we are facing inadequate public schools, with many on the verge of bankruptcy, skyrocketing tuition and declining quality at our colleges and universities, a crumbling infrastructure, an inadequate but expensive health care system, and upward pressure on local property taxes. While by no means a complete list, these are all factors that will severely damage Michigan's long-term growth prospects. Low taxes have their place, but this can be carried too far and result in an inadequate level of public services.

As shown in Exhibit 1, Michigan's state and local tax burden is now below the national average. In FY 1985–86, Michigan revenues as a percentage of personal income were 9.4 percent above the national average, and Michigan ranked 14th highest among the 50 states. In FY 1990–91 (latest data available), Michigan state and local revenues were right at the national average. The FY 1990–91 rank is not available, but Michigan ranked 26th in 1989–90.

Michigan has not enacted a permanent, major tax increase since 1971, when the personal income tax was increased from 2.6 to 3.9 percent. In 1967, the state first adopted a tax on income. The rate was increased to 4.6 percent in 1975 to replace the sales tax on food and drugs, which was repealed by the voters in November 1974. In 1976 the single business tax (SBT) was enacted, but it replaced seven taxes and was designed to be revenue neutral. In 1982 and 1983 the personal income tax was increased on a temporary basis, with the

EXHIBIT 1

Michigan State-Local Revenue as a Percentage of Personal Income, Selected Sources, FY 1985–86 and FY 1990–91

	FY1985–86			FY 1990–91		Rank	
State-Local Own-Source Revenue	Percent of Personal Income	Percent of U.S. Average	Rank	Percent of Personal Income	Percent of U.S. Average	1989–90	1990–91
Income tax	2.33%	110.4%	NA	2.44%	104.2%	NA	NA
Sales tax	3.09	75.8	44	2.66	67.2	44	44
Property tax	4.80	142.5	6	4.90	134.4	11	NA
Total	17.50	109.4	14	16.00[a]	100.0	26	NA

SOURCE: U.S. Department of Commerce, Bureau of Census, *Governmental Finances*, selected issues. Calculations by Public Sector Consultants, Inc.
[a]Adjusted for change in accounting treatment of tax credits.

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February 12, 1993

rate falling back to 4.6 percent in 1986. The only significant tax increases that have been enacted during the past 20 years have been on cigarettes, liquor, and gasoline.

In addition, there have been a number of reductions in the bases of many taxes, principally the SBT, sales and use taxes, and inheritance tax. According to a 1990 report by the House Fiscal Agency, tax expenditures (tax deductions, exemptions, and credits) increased 52.5 percent from FY 1982 to FY 1988 compared with a 46.9 percent increase in general fund/general purpose (GF/GP) expenditures.[1] State tax expenditures exceeded $7.5 billion in FY 1989–90.

No more than five states have failed to enact a major tax increase in the past 20 years. For example, since 1978, 35 states have raised the sales tax rate. It should be no surprise then that our tax burden ranking among the states has fallen sharply in the past several years.

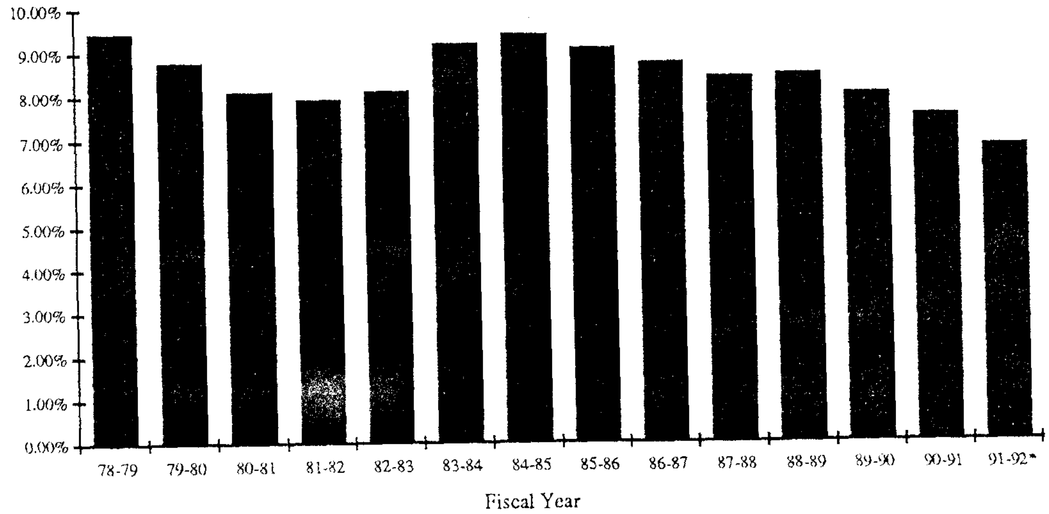
DECLINING STATE REVENUE

Several measures explain what has happened to state revenues in the last two decades. First, the state constitution limits state revenue (less federal aid and revenue from several other sources) to 9.49 percent of Michigan personal income, the actual percentage in FY 1978–79 (as a percentage of 1977 personal income). As shown in Exhibit 2, state revenue as a share of personal income has fallen to about 6.9 percent of personal income in FY 1991–92 (as a percentage of calendar year 1990 income). The share rose in the early 1980s, due to the temporary increase in the income tax, but since FY 1985–86, state revenue as a share of total revenue has steadily declined.

In FY 1991–92 state revenue was about $4.5 billion below the constitutional limit. In other words, state government revenues would be $4.5 billion higher if revenue growth had matched personal income growth. This decline is due in part to the weak economic growth since 1987, but it is also a result of the falling elasticity

EXHIBIT 2

State Revenue Limit: Revenue as a Percentage of Personal Income, FY 1978–79 to 1991–92 (limit equals 9.49 percent of income)



SOURCE: Senate Fiscal Agency, *1992 Statistical Report*, November 1992.
*SFA estimate.

1 House Fiscal Agency, *Silent Spending: Tax Expenditures and the Competition for Public Dollars*, May 1990.

of the revenue system. By elasticity we mean the responsiveness of revenue to economic growth. In the late 1970s a one percent increase in personal income produced almost a one percent increase in revenue. Today, revenue increases less than 0.8 percent for each one percent increase in personal income. This is shown in Exhibit 3.

The elasticity of the tax system will increase as the economy improves, but not to the level of the 1970s and mid-1980s. This is largely because of Michigan's changing economy, the state's failure to tax the fastest growing sectors, and the continual erosion of the tax base.

Second, real state taxes per worker have declined. From FY 1978–79 to FY 1991–92 the average tax burden per worker increased from $1,658 to $2,850, a 71.9 percent increase. Adjusted for inflation, however, the tax burden fell from $1,658 to $1,576, a 5 percent decline.

Third, as shown in Exhibit 4, state taxes have declined from 7 percent of personal income in FY 1978–79 to 6.3 percent in FY 1991–92. (The jump to 7.4 percent in FY 1983–84 was due to the temporary increase in the rate of the state income tax.) All the major taxes have declined as a share of personal income, with most of the decline occurring since FY 1987–88.

EXHIBIT 3

Comparison of Michigan Personal Income and State Taxes, Selected Periods

Fiscal Year	Percent Change in Personal Income	Percent Change in State Taxes	Elasticity (ratio)
1972–73 to 1978–79	79.0%	77.5%	.98
1972–73 to 1988–89	230.0	222.2	.97
1978–79 to 1988–89	84.5	81.5	.97
1978–79 to 1991–92	106.2	84.1	.79
1972–73 to 1991–92	269.0	226.7	.84
1988–89 to 1991–92	11.8	1.4	.12

SOURCE: Calculated by Public Sector Consultants, Inc.

RECOMMENDATIONS

Michigan should enact major changes in its tax structure to make it more responsive to economic growth, able to produce sufficient revenues to fund an adequate level of public services, more equitable and simpler for the taxpayer, and more balanced among the major revenue sources, while maintaining an overall tax burden that is close to the national average. These proposed changes are explained below.

1. Adopt a new tax expenditure review process.

The tax base has been eroded over the years by numerous deductions, credits, and exemptions. These "tax expenditures" are not regularly reviewed as are annual appropriations and tend to remain in place long after they have served their purpose. It makes no sense to slash spending during difficult economic times and not consider eliminating tax expenditures that may be ineffective. See our April 24, 1992, report "Tax Expenditures: It's Time to Change the Process" for recommendations for a new process to classify and review tax expenditures on a regular basis. This process would be an important first step in protecting the tax system from continued, often unwarranted, erosion.

2. Enact an ad valorem cigarette and gas tax.

Unlike the sales tax, cigarette, alcohol, and gas tax revenues do not increase as prices increase, as these taxes are levied on a per pack and per gallon basis. As smoking has declined and motor vehicles have become more fuel efficient, revenues from these taxes have declined or grown very slowly. The only significant growth has come from rate increases. Gas tax revenues have declined from 0.67 of personal income in FY

EXHIBIT 4

Selected Michigan Taxes as a Percentage of Michigan Personal Income, FY 1971–FY 1992

Fiscal Year, Total State Taxes	Percentage of Personal Income Income Tax	Sales and Use Taxes	SBT[a]	Gas Tax	Sin Taxes	
1970–71	6.2%	1.19%	2.20%	—	0.67%	0.47%
1971–72	6.7	1.64	2.23	—	0.64	0.45
1972–73	7.1	1.85	2.22	—	0.66	0.42
1973–74	6.9	1.81	2.22	—	0.71	0.40
1974–75	6.6	1.71	2.24	—	0.66	0.39
1975–76[b]	8.2	2.46	2.37	0.56	0.76	0.44
1976–77	6.8	2.03	1.95	1.12	0.56	0.31
1977–78	6.9	2.13	1.97	1.12	0.51	0.29
1978–79	7.0	2.19	1.96	1.13	0.53	0.26
1979–80	6.7	2.03	1.85	1.14	0.48	0.24
1980–81	6.4	2.03	1.84	0.94	0.42	0.24
1981–82	6.6	2.26	1.80	0.93	0.43	0.28
1982–83	7.0	2.57	1.84	0.93	0.40	0.31
1983–84	7.4	2.76	1.90	1.09	0.45	0.28
1984–85	7.3	2.55	1.95	1.08	0.45	0.26
1985–86	7.1	2.32	1.97	1.12	0.44	0.24
1986–87	7.0	2.35	1.93	1.05	0.42	0.23
1987–88	7.1	2.35	1.88	1.18	0.41	0.23
1988–89	6.9	2.31	1.89	1.13	0.38	0.23
1989–90	6.7	2.29	1.84	1.05	0.37	0.22
1990–91	6.4	2.18	1.80	0.89	0.36	0.21
1991–92	6.3	2.09	1.76	0.91	0.35	0.20

SOURCE: Calculated by Public Sector Consultants from data provided by the Senate Fiscal Agency and the Department of Management and Budget.
[a]The single business tax (SBT) was not in effect until the 1976 tax year.
[b]The percentages for FY 1975–76 are inflated because the fiscal year covered 15 months.

1970–71 to 0.45 percent in FY 1984–85 to 0.35 percent in FY 1991–92 despite an increase in the gas tax rate from 7 cents to 15 cents per gallon. (See Exhibit 4.) The revenue yield per penny has increased only 10.5 percent since FY 1970–71, from $38.1 million to $42.1 million.

Cigarette tax collections have declined from 0.31 percent of personal income in FY 1970–71 to 0.14 percent in FY 1991–92, although the tax rate has increased from 11 cents to 25 cents per pack. The yield per penny has fallen 10.8 percent over the past two decades, from $11.1 million to $9.9 million. Levying these taxes on the retail price of the product would produce more revenue and reduce the need for periodic tax rate increases.

3. Broaden the base of the SBT and lower the rate.

Two of the main purposes for enacting the SBT were to simplify the tax system and stabilize business revenues. Over the years these advantages have slowly been lost. The law contains numerous special preferences that complicate the tax and reduce its stability.

SBT collections have increased at a faster rate than personal income since its inception, but the tax has become more unstable and more unpopular, partly because of its complexity. Our view is that a simpler tax with a lower rate would be more appealing to the business community. The only tax preferences that should be provided are a small base exemption (no more than $40,000, indexed for inflation), a credit for hiring new workers (with a higher credit if the new employee were previously on public assistance), and possibly a credit for certain types of investment, although the current capital acquisition deduction provides generous treatment for new investments.

4. Extend the sales tax to a broad range of services.

Sales tax collections have declined from 1.96 percent of personal income in FY 1978–79 to 1.76 percent in FY 1991–92, in part because services, the fastest growing sector of the economy, largely escape taxation. Extending the sales tax to services could generate as much as $1.2 billion in revenue. The most likely candidates for taxation are amusements, auto-related services, miscellaneous repair, some business services (accounting, consulting, etc.), and personal services (dry cleaning, beauty shops, etc.). Taxation of these services would raise about $500 million annually. (See our July 17, 1992, report "Cashing in on a Service Economy: Expanding the Sales Tax" for a fuller discussion of this issue.)

There are three good reasons for extending the sales tax to cover most services. First, taxing some forms of consumption and not others is inequitable and is only justified if the exemption makes the sales tax less regressive, as in the case of the exemption of food and drugs. Second, services are the fastest growing sector of the economy; failure to tax this sector slows the growth in state revenue and increases pressure for other tax increases and budget reductions. Third, many states are experiencing severe budget problems, and taxes on services are the largest source of revenue available without raising tax rates.

This is the most logical revenue source in Michigan because of our relatively low sales tax burden. Sales tax collections in Michigan in FY 1990–91 were 2.66 percent of personal income, about 33 percent below the national average, ranking Michigan 44th among the 45 states that levy a sales tax. Even if additional revenue is not needed, the fairness and growth potential of the sales tax could be improved by extending it to services and reducing the rate to maintain the same amount of revenue.

5. Improve the balance of the tax system.

One criterion for a high quality state-local tax system is that it be balanced among the three major revenue sources: income, sales, and property. The rule of thumb is that each of these sources should provide 20–30 percent of total states local revenues. In Michigan the property tax accounts for well over 30 percent of revenue, while the sales tax accounts for less than 20 percent of revenue (see Exhibit 5). Clearly, Michigan should reduce the property tax burden and increase the use of the income and, particularly, the sales tax.

Our recommendation is that school property taxes be reduced 20–30 percent, preferably by reducing the school operating millage rate, the truth-in-taxation law be amended to require a vote of the people for any

EXHIBIT 5

Major State-Local Revenue Sources, Michigan and United States, 1989–90

Source	Michigan		United States	
	Amount (millions)	Percent of Total	Amount (millions)	Percent of Total
Sales tax	$3,187.7	16.6%	$121,286.7	24.2%
Personal income tax	4,324.0	22.5	105,841.0	21.1
Property tax	7,618.0	39.6	155,613.3	31.0
Other	4,089.6	21.3	118,878.3	23.7
Total	$19,219.3	100.0	$501,618.6	100.0

SOURCE: U.S. Department of Commerce, Government Finances, 1989–90. Calculations by PSC. Inc.

assessment increases that increase revenues more than 2 percent above the rate of inflation, and the personal property tax on machinery and equipment be phased out over a ten-year period. These revenues should be replaced by extending the sales tax to certain services, as recommended above, by repealing the property tax abatement law (although the state should be allowed to grant abatements in special cases), and by raising the rates of the income and single business taxes.

The property tax reductions would cost about $2 billion in 1992 dollars. The phase-out of the tax on machinery and equipment, however, would cost about $100 million each year. These reductions would require about a 0.5 percent increase in the rates of the income and single business taxes, in addition to the other proposed revenues.

We also recommend an additional 0.5 percent increase in the income tax to provide more adequate funding for K-12 and higher education.

These changes would improve the balance of the tax system and its growth potential (by increasing reliance on the more responsive income tax and SBT and slowing the growth in property tax credits) as well as the Michigan business climate. (State financed property tax credits increased from $633 million in FY 1987–88 to $828 million in FY 1990–91, an annual increase of 9.4 percent.)