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THE MICHIGAN STATE-LOCAL TAX SYSTEM: HOW DOES IT RATE?

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In 1985 Public Sector Consultants published a report that rated the state-local fiscal systems of the fifty states on the basis of five factors: revenue balance, tax equity, state fiscal equalization, property tax administration, and the business climate. We recently updated this rating system in a report titled "U.S. State-Local Tax Systems: How Do They Rate?" The update presents the criteria for a high-quality state-local tax system and the methodology used to rate the fifty states.[1]

This paper, prepared for our Michigan clients, discusses the Michigan state-local tax system in particular. It presents an abbreviated discussion of the criteria for a high-quality tax system; examines Michigan's major revenue sources and how well they meet the criteria; analyzes how Michigan fares in the five fiscal tests; and suggests changes to improve Michigan's overall ranking of 10th among all the states. Technical and taxation terms are defined in a glossary at the end of the paper.

In the 1985 report, Michigan ranked 23rd among the fifty states. The state scored high on property tax administration and tax equity but low on business climate and state fiscal equalization. Michigan has moved up to 10th in the new ratings, due mainly to improvement on the tax equity and revenue balance tests. A revision in the business climate test to include the level of public services provided improved Michigan's relative score, although not its rank. (See Exhibit 1 for a comparison of Michigan's 1985 and current rankings.)

Michigan's State-Local Tax System

Personal Income Tax

The income tax is generally considered the cornerstone of a tax system, as it is the fairest and most productive revenue source available to state and local governments.

In Michigan, the state income tax accounts for 23.2 percent of total state-local revenue compared with 20 percent nationwide. Local income taxes

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[1] The 1985 report was based largely on fiscal year 1983 data. The update uses fiscal years 1985, 1986, and 1987 data when available.

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EXHIBIT 1

COMPARISON OF 1985 AND 1988 RANKINGS FOR MICHIGAN

	1988 Rank	1985 Rank
Revenue balance	29	31
Tax equity	7	14
State fiscal equalization	41	46
Property tax administration	6	6
Business climate	49	45
OVERALL	10	23

SOURCE: Public Sector Consultants, Inc.

are levied in sixteen Michigan cities.[2] State and local income taxes vary in rates, deductions, exemptions, income definitions, and administration. There is no prescription for the perfect income tax, but there are several generally agreed upon criteria that should be given weight in the design of a state or local income tax.

- A personal income tax should provide 20 to 35 percent of all state-local tax revenue.
- The rates of an income tax, whether graduated or flat, should not be markedly higher than rates in surrounding states.
- A state or local income tax should offer personal exemptions or credits at least as generous as the federal income tax exemptions.
- The number of deductions allowed on state or local income taxes should be minimized.
- State and local income taxes should be indexed for inflation.
- A state should share the proceeds of the personal income tax with local units of government or permit, with proper safeguards, local income taxation.

In Michigan, all these criteria are met well except for indexing (which appears less critical during periods of low inflation). Recent legislation will increase the current state income tax $1,500 personal exemption to $2,100 by 1990; the local income tax personal exemption remains set by state law at only $600.

[2] State statute grants cities the authority, but the voters must approve the levying of the tax. The tax bases, exemptions, and the rate ceiling are set by state law. The bases and exemptions are the same for all sixteen cities; the rates differ somewhat.

Sales Tax

In Michigan, the state sales tax accounts for 17.2 percent of total state-local tax revenue and 12.4 percent of total own-source revenue. Nationally, the sales tax provides 24.3 of state-local tax revenue and 17.2 percent of total own-source revenue.

The sales tax deserves heavy weight in a state-local tax system because it is (1) productive, (2) relatively stable, (3) exportable to nonresidents, particularly in high tourism states, and (4) the least unpopular tax, according to most public opinion surveys, because it is viewed as voluntary by the taxpayer and is collected in small amounts.

Conventional wisdom holds that a good state sales tax should meet six criteria.

- A state sales tax should provide 20 to 30 percent of all state-local tax revenue.
- The rate of the sales tax should not be out of line with rates in surrounding states.
- The tax should exempt food, drugs, and utilities or provide a tax credit for purchase of these items.
- It should tax most services as well as goods.
- The proceeds of the sales tax should be shared with local governments, or localities should be allowed to levy sales taxes subject to state-imposed safeguards.
- A strong audit and enforcement program should be maintained to protect the integrity of the tax base.

The Michigan sales tax does not fare as well against the criteria as does the Michigan income tax. The sales tax is somewhat underutilized, partly because most services are not subject to taxation. Food and drugs are exempt from the sales tax, but utilities are taxed.

On the positive side, the 4 percent rate is the lowest in the Great Lakes region and below the U.S. median rate of 4.75 percent. Also, 15 percent of the proceeds of the sales tax are shared with local units of government. Local sales taxes are not permitted in this state, although their use has proliferated elsewhere.

Property Tax

Property taxes are the preeminent local revenue source and will continue to be for the foreseeable future, despite a recent trend toward more diversification in local revenue systems. Nationally, in 1970, local property taxes accounted for 64 percent of local own-source revenue. By 1986, the property tax share had fallen to 46 percent because local governments had begun to make greater use of sales and income taxes and user charges. In Michigan, the decline has been much more modest, falling from 66.4 percent of local own-source revenue in 1970 to about 61 percent in 1986; if an adjustment were made for state-provided property tax relief, however, the decline would be more dramatic, to 54.3 percent in 1986.

The property tax is the most criticized of the major taxes used by state and local governments, mainly because the tax (1) is unfair (regressive), (2) discourages improvements on property, and (3) encourages flight from central cities. The tax also has several important advantages, such as stability, productivity, and accountability. The virtues of a property tax can be maximized and the weaknesses minimized by adopting certain safeguards.

- Property taxes should provide 20 to 30 percent of all state-local tax revenue.
- State and local government should work together to ensure that the property tax burden does not become excessive.
- States should finance a "circuit-breaker" property tax relief program to shield low-income taxpayers from excessive tax burdens.
- Property should be assessed on average at no less than 80 percent of full market value (100 percent is the ideal).
- Property tax laws should include a mechanism to prevent automatic, unrestrained increases in revenue from inflation-induced assessment increases.
- Property taxes should be administered fairly and equitably.

Property taxes in Michigan meet most of these criteria. The state provides one of the nation's most generous property tax relief programs; there is a constitutional restraint on property tax increases and a "truth-in-taxation" law;[3] and Michigan scores well in administering the property tax, placing sixth among the states in the rankings presented later in this paper. Michigan falls short in two areas. Property is assessed at 50 percent of market value, less than the recommended 80 percent, and the tax is overutilized. Only in five states is there greater reliance on property taxes. In Michigan, property taxes provide 38.2 percent of all state-local tax revenue and 27.5 percent of total state-local own-source revenue. Nationally, these figures are 29.9 percent and 21.1 percent, respectively.

The heavy property tax burden in Michigan is related, in large part, to the state's poor performance in fiscal equalization (providing financial assistance to local governments). In Michigan, the state picks up only 35.2 percent of the total cost of local education compared with a national average of 49.6 percent--only five states provide less support than Michigan.

Business Taxes

There is less agreement on the criteria for a good state-local business tax system than there is on the criteria for individual taxes, largely because of the complexity and uncertain incidence of business taxes. These taxes have been receiving more attention in recent years because states desire to maintain a favorable business climate and remain competitive with other states. Although there is not general agreement on how the ideal business tax system should be structured, the following criteria provide a framework for a good state-local business tax system.

- A business tax system should be broadly based and give some consideration to ability to pay.
- Business taxes should be applicable to all forms of business organization.

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[3] This law requires local governments to announce property tax increases in the newspaper whether they are due to higher assessments or increased millage rates and requires the governing body to hold a public hearing and formally vote on the increase.

- An immediate write-off for capital investment should be allowed, but special tax inducements generally should not be offered.
- The number of separate taxes within a business tax system should be kept to as few as possible.
- A stable tax base should be used.
- States should provide replacement revenue to local governments so locals can repeal personal property taxes on inventories.
- Rates should be moderate for unemployment insurance and workers' compensation as well as for general business taxes.

Michigan meets most of these criteria, largely because of the single business tax, a modified value-added tax, adopted in 1976. The major shortcomings in Michigan's business tax system are the high rates for unemployment and workers' compensation, although progress has been made on this front in recent years.

The Report Card on Michigan

This section discusses how Michigan scores on each of five fiscal tests, compares Michigan's 1985 and 1988 ratings on each test, and explains any revisions in the methodology used. (See Exhibit 2 for the scores and rankings of all fifty states on each of the five tests.)

Revenue Balance

This test measures how balanced (diversified) a state's revenue system is in use of the "big three" revenue sources--personal income tax, general sales tax, and local property tax. Michigan ranks 29th among the states compared with a rank of 31st in 1985. The relatively poor showing results from over-utilizing property taxes and underutilizing the sales tax. The income tax falls within the recommended 20 to 30 percent range. The small improvement since 1985 is due to a decline in the reliance on property taxes from 41.6 percent of state-local taxes to 38.5 percent and an increase in the sales tax from 15.8 percent to 17.4 percent.

Tax Equity

This test measures the overall fairness of a state-local tax system in terms of progressivity (or elasticity) of the tax structure, property tax and sales tax relief for low-income taxpayers, inflation protection for all taxpayers, and the use of a broadly based sales tax to ensure equitable treatment for all forms of consumption. Michigan ranks 7th among the states compared with a 1985 rank of 14th. The improvement is due to inclusion of a progressivity or elasticity measure in the test. In 1985, this measure was included in an overall fiscal system test that has been eliminated.

State Fiscal Equalization

This test measures how well states equalize fiscal resources, that is, how much fiscal support they give their local governments specifically for welfare, education, health and hospitals, highways, and, through general revenue sharing, other services. Fiscal equalization is important because local governments have less total revenue raising ability than state governments. Michigan ranks 41st compared with a rank of 46th in 1985. The improved ranking is due to increases in the share of health and hospitals and local education costs financed by the state. The only change in the test from

EXHIBIT 2

THE FINAL REPORT CARD: A RATING OF THE FIFTY STATE-LOCAL TAX SYSTEMS ON FIVE TESTS
(test rank in parentheses)

Overall Rank	State	Grand Total [220 Possible]	Revenue Balance [50 Possible]	Tax Equity [50 Possible]	State Fiscal Equalization [50 Possible]	Property Tax Administration [35 Possible]	Business Climate [35 Possible]	Comparison: 1985 PSC Rankings
	United States	132.1	36.3	34.7	28.1	11.0	22.0	
1	Kentucky	171.7	48.3(8)	34.0(30)	35.2(6)	29.9(2)	23.8(16)	1
2	Idaho	165.0	50.0(1)	36.0(25)	29.9(22)	27.9(4)	21.2(33)	2
3	Maryland	164.7	44.7(19)	46.5(2)	25.7(32)	23.1(10)	24.7(13)	4
4	Virginia	157.9	46.7(12)	31.0(36)	22.7(37)	31.9(1)	25.6(8)	3
5	Ohio	156.4	50.0(1)	41.2(8)	22.5(39)	21.0(12)	21.7(30)	6
6	Iowa	151.0	40.6(25)	44.0(5)	19.1(43)	24.6(8)	22.7(27)	22
7	Wisconsin	150.5	43.6(22)	47.7(1)	27.5(25)	12.0(17)	19.7(38)	9
8	Georgia	146.0	50.0(1)	28.0(40)	27.1(27)	13.9(14)	27.0(4)	11
9	South Carolina	145.3	50.0(1)	37.0(22)	34.8(9)	0.0(41)	23.5(21)	7
10	MICHIGAN	143.3	38.9(29)	43.0(7)	20.8(41)	27.0(6)	13.6(49)	23
11	Hawaii	143.2	39.6(26)	37.0(22)	39.3(4)	10.0(21)	17.3(44)	18
12	North Carolina	141.8	50.0(1)	32.0(35)	29.9(22)	6.3(33)	23.6(19)	12
13	Pennsylvania	141.4	48.4(9)	39.6(17)	26.7(28)	5.0(34)	21.7(30)	17
14	Arkansas	140.0	45.6(15)	37.2(21)	33.4(15)	0.0(41)	23.8(16)	13
15	Maine	140.0	43.7(21)	40.5(12)	29.7(24)	12.9(16)	13.2(50)	8
16	California	139.2	50.0(1)	33.9(32)	34.9(8)	4.9(36)	15.5(47)	19
17	Colorado	138.8	44.9(17)	46.0(3)	18.9(44)	7.4(32)	21.6(32)	16
18	Utah	138.4	47.3(11)	34.8(28)	30.2(21)	9.4(25)	16.7(45)	10
19	New Jersey	138.3	30.7(35)	41.0(9)	30.9(20)	10.0(21)	25.7(7)	30
20	North Dakota	137.8	38.2(30)	41.0(9)	35.1(7)	1.0(40)	22.5(29)	21
21	Illinois	137.6	39.6(26)	38.0(19)	19.8(42)	17.2(13)	23.0(25)	24
22	Arizona	136.9	36.8(31)	44.0(5)	32.4(18)	8.1(30)	15.6(46)	4
23	Rhode Island	136.9	39.1(28)	41.0(9)	26.4(29)	9.4(25)	21.0(34)	33
24	Florida	136.4	23.2(40)	34.6(29)	27.3(26)	28.0(3)	23.3(22)	26
25	Indiana	136.0	45.5(16)	33.4(33)	32.4(18)	1.6(39)	23.1(24)	31
26	Alaska	135.6	15.1(47)	25.4(42)	44.7(2)	26.8(2)	23.6(19)	35
27	New Mexico	134.5	21.0(43)	40.0(16)	46.4(1)	0.0(41)	27.1(3)	39
28	Minnesota	134.5	48.3(10)	31.0(36)	32.6(17)	8.3(29)	14.3(48)	27
29	West Virginia	133.9	44.2(20)	36.8(24)	34.3(10)	0.0(41)	18.6(40)	34
30	Massachusetts	133.8	41.3(23)	29.9(38)	34.1(11)	10.0(21)	18.5(41)	20
31	Oklahoma	132.9	45.8(14)	34.0(30)	34.1(11)	0.0(41)	19.0(39)	25
32	Delaware	132.3	29.2(36)	19.6(48)	39.8(3)	13.9(14)	29.8(1)	41
33	Nebraska	131.4	31.8(34)	36.0(25)	12.8(50)	21.8(11)	29.0(2)	28
34	Kansas	129.4	41.3(23)	38.0(19)	22.7(38)	2.5(37)	24.9(12)	32
35	Alabama	129.3	44.8(18)	24.4(45)	34.0(13)	1.8(38)	24.3(14)	15
36	Mississippi	126.7	31.9(33)	33.0(34)	37.8(5)	0.0(41)	24.0(15)	29
37	Missouri	125.6	46.0(13)	36.0(25)	18.6(45)	0.0(41)	25.0(10)	13
38	Oregon	125.5	21.5(42)	40.5(12)	15.5(48)	27.4(5)	20.6(36)	36
39	Connecticut	123.3	26.4(38)	40.4(14)	23.9(36)	10.0(21)	22.6(28)	43
40	Vermont	123.3	33.1(32)	44.5(4)	22.4(40)	0.0(41)	23.3(22)	37
41	New York	122.0	49.2(7)	38.4(18)	16.8(47)	0.0(41)	17.6(43)	40
42	Washington	120.7	15.0(48)	25.1(43)	33.6(14)	23.3(9)	23.7(18)	38
43	Montana	113.4	15.9(45)	40.4(14)	26.1(31)	10.2(20)	20.8(35)	46
44	Nevada	111.9	25.7(39)	26.0(41)	24.0(35)	10.3(19)	25.9(6)	42
45	Louisiana	107.4	28.0(37)	21.0(46)	33.2(16)	0.0(41)	25.2(9)	44
46	Texas	95.1	23.2(40)	24.5(44)	24.2(34)	5.0(34)	18.2(42)	47
47	Tennessee	91.7	16.3(44)	18.0(50)	24.7(33)	7.7(31)	25.0(10)	45
48	Wyoming	91.3	14.0(49)	19.5(49)	26.2(30)	8.7(28)	22.9(26)	49
49	South Dakota	89.1	15.4(46)	20.9(47)	17.4(46)	8.8(27)	26.6(5)	48
50	New Hampshire	76.5	2.2(50)	28.7(39)	14.3(49)	11.0(18)	20.3(37)	50

SOURCE: Public Sector Consultants.

the 1985 report is that a better measure was available for general revenue sharing.

Property Tax Administration

This test equates uniformity in administration with fairness. Michigan ranks 6th among the states on this test. There has been no change since 1985, as updated information is not available. The data used to measure the uniformity of property tax assessments are published every five years by the U.S. Census Bureau, and new data will not be available until later this year at the earliest.

Business Climate

Michigan ranks 49th on this test compared with a ranking of 45th in 1985. The poor ranking is due mainly to high workers' compensation and unemployment insurance costs and an above-average state-local tax burden.

Because factors such as geography, labor costs, and the quality of the work force are more important in business location decisions than is tax policy, a state that receives a poor rating on this test may still be attractive to business. The best measure of a state's business climate may be its growth in employment. Several states with a below-average score on this test achieved above-average employment growth between 1978 and 1985. In Michigan, however, employment declined 2.9 percent during this period--only two states did worse.

Conclusion

Michigan has a good state-local tax system as evidenced by its overall rank of 10th among all the states, but there is still room for improvement. The following changes would further improve the quality of Michigan's state-local tax system.

- Reduce reliance on local property taxes through enacting school finance reform.
- Extend the state sales tax to a broad range of services. These revenues could be used for school finance reform.
- Exempt residential utilities from the sales tax.
- Reduce the number of credits and exemptions allowed on the single business tax and reduce the rate.
- Eliminate the property tax abatement program, and use the savings to reduce personal property taxes on business (mainly on machinery and equipment).
- Continue to lower unemployment and workers' compensation costs.
- Increase gradually the personal exemption allowed on local income taxes from $600 to $2,100 (the level the state personal income tax exemption will reach in 1990). The state could compensate cities for the revenue they would lose because of a higher exemption by increasing state general revenue sharing payments to cities or by permitting the cities to increase their tax rates.
- Revise the state revenue sharing formula to reflect more accurately public expenditure needs and increase total aid to local governments. A tax base sharing program should be enacted in such metropolitan areas as Detroit and Flint.
- Reduce the number of property tax assessing districts, provide statewide assessment for large commercial and industrial properties,

and put more state resources into property tax administration at the state and local level.

The ratings in this 1988 report represent only one view of state-local fiscal systems. A rank in the top ten does not mean that a state has achieved fiscal nirvana, nor does a rank in the bottom ten mean that a state has an inadequate fiscal system. It is hoped that these ratings will encourage Michigan (and other states) to take a critical look at their state-local tax systems, whatever their rank.

GLOSSARY

CIRCUIT-BREAKER A property tax relief program that bases the amount of relief on the income of the property owner.

ELASTICITY A measure of how responsive the growth of the base of a tax is to economic growth. For example, a highly elastic tax will grow faster than the economy.

FISCAL EQUALIZATION Aid provided by a higher level of government to a lower level of government to compensate for the latter's limited ability to generate sufficient revenue.

GENERAL REVENUE SHARING Aid payments that are unrestricted as to how they can be used, made by the federal government to state governments and by state governments to local governments.

INCIDENCE The tax burden upon a person; it may or may not be shifted to someone else.

INDEXING The adjustment of tax rates, tax credits, and exemptions for inflation. For example, the value of the personal income tax exemption would be increased by the annual percentage increase in the consumer price index.

OWN-SOURCE REVENUE The revenue generated by a unit of government from its own tax base; this excludes aid from another level of government.

REGRESSIVE TAXATION A tax or tax system that takes a larger proportional share of the income of low-income persons than of high-income persons.

TAX BASE SHARING A method of redistributing property tax revenues among local units of government in a metropolitan area. Typically, some share of the growth in commercial and residential property taxes is placed in a pool and redistributed on a formula basis to all local units in the tax base sharing district.

TRUTH-IN-TAXATION LAW A law that requires property tax rates to be rolled back to offset assessment increases, unless the appropriate governing body formally votes to allow an increase in property taxes.

VALUE-ADDED TAX A tax levied on the value added during the processing of a raw material or service. This value takes the form of labor, interest, rent, and profits.