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Analysis of Proposal C

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Tax Limitation in Michigan: The 1984 "Voter's Choice" Ballot Proposal

Government limitation initiatives are not new, either in Michigan or the nation. Proposal C is an extreme measure -- vastly broader in scope than the property tax limitation measures passed in California and Massachusetts. Proposal C attempts to wrest from the legislature the constitutional power to set all tax policy and to transfer that power to the voters. If approved, interpretation, implementation, and compliance problems with Proposal C could have serious negative legal, fiscal, and economic consequences for the entire state of Michigan and for governing units at all levels.

On November 6, Michigan voters will consider three proposed amendments to the state constitution. This article examines one of these measures, Proposal C, commonly referred to as "Voter's Choice." A condensed version of the amendment will appear on the ballot because Article XII, Section 2 of the Michigan constitution requires that the ballot "contain a statement of the purpose of the proposed amendment, expressed in not more than 100 words, exclusive of caption." The full text of the proposed amendment is on file with the Secretary of State and is presented here for reference.

Limitation Measures

Government limitation measures fall generally into three broad categories: restrictions on tax rates, tax revenues, and government expenditures. All three are in Michigan's constitution or in state law. Article IX, Section 8 of the constitution limits sales and use tax rates to a maximum of 4%. Article IX, Sections 25-34 limit the rate of growth of total state tax revenues and of state spending and require that 41.6% of spending from state sources be used in support of local government programs. Both of these constitutional limitations may be exceeded temporarily only if the legislature, by a 2/3 vote, declares a state of emergency. In a related vein, Public Act 5 of 1982 (Truth in Taxation) limits the operating property tax revenue a local unit of government may collect on existing property to the dollar amount collected on that property in the prior year. If equalized values have increased, local units must reduce their millage rates so that the number of tax dollars collected does not exceed those collected on existing property in the prior year. The same act allows governing bodies, after a public hearing, to vote to restore all or part of the millage rollback.

Proposal C

Critics have charged that these limitation measures have been ineffective in preventing tax increases and in freezing government spending. In an attempt to correct this, an amendment to Michigan's constitution has been initiated and approved for vote on the November 6 ballot.

Designated as Proposal C on the ballot, in brief, the proposed constitutional amendment would:

- Prohibit legislative changes in the base or rate of any state or local tax that would increase its revenue yield, unless approved by voters.
- Prohibit the adoption of any new state or local tax or fee unless approved by voters.
- Make void 90 days after the adoption of the amendment:
  - -- New state or local taxes, or increases in the rate or base of state or local taxes, imposed after December 31, 1981, unless authorized by the voters;
  - -- License, user, or permit fees that were adopted or increased after December 31, 1981, unless authorized by voters or approved by a 4/5 vote of the adopting legislative body.

"Article IX of the Michigan Constitution is hereby amended by amending Sections 1 and 2, such amendments to read as follows (NEW LANGUAGE CAPITALIZED).

ARTICLE IX

"Section 1. The legislature shall impose taxes sufficient with other resources to pay the expenses of state government WITHIN THE LIMITATIONS OF SECTION 2 OF THIS ARTICLE.

"Section 2. The power of taxation IS DERIVED FROM THE PEOPLE AND shall never be surrendered, suspended or contracted away FROM THE PEOPLE. AFTER DECEMBER 31, 1981 THERE SHALL BE NO LEGISLATIVE CHANGE IN THE BASE OR RATE OF ANY STATE OR LOCAL TAX WHICH WOULD INCREASE ITS REVENUE YIELD NOR SHALL THERE BE ANY NEW TAX UNLESS APPROVED BY A MAJORITY OF THE QUALIFIED ELECTORS VOTING ON THE QUESTION.

"EVERY PROPOSAL FOR A TAX REVENUE INCREASE OR NEW TAX SHALL STATE THE TOTAL ANTICIPATED REVENUE, THE PURPOSE TO WHICH THE FUNDS SHALL BE DEVOTED AND THE DATE OF EXPIRATION.

"AFTER DECEMBER31, 1981, THERE SHALL BE NO LEGISLATIVE CHANGE IN ANY FEE, LICENSE, USER FEE OR PERMIT OF THE STATE OR ANY POLITICAL SUBDIVISION THEREOF WHICH WOULD INCREASE THE REVENUE YIELD NOR SHALL THERE BE ANY NEW FEE, LICENSE, USER FEE OR PERMIT WHICH WOULD YIELD A REVENUE INCREASE UNLESS APPROVED BY A 4/5 AFFIRMATIVE VOTE OF THE RESPONSIBLE LEGISLATIVE BODY OR APPROVED BY A MAJORITY OF THE QUALIFIED ELECTORS VOTING ON THE QUESTION.

"AFTER DECEMBER 31, 1981 ANY LEGISLATIVE CHANGE IN THE RATE OR BASE OF ANY STATE OR LOCAL TAX WHICH INCREASES ITS REVENUE YIELD AND ANY NEW TAX SHALL BE INVALID ON AND AFTER THE NINETIETH DAY FOLLOWING THE ADOPTION OF THIS AMENDMENT UNLESS AND UNTIL APPROVED BY THE ELECTORATE AS HEREIN PROVIDED.

"AFTER DECEMBER 31, 1981 ANY LEGISLATIVE CHANGE IN ANY FEE, LICENSE, USER FEE OR PERMIT OF THE STATE OR ANY POLITICAL SUBDIVISION THEREOF WHICH INCREASES THE REVENUE YIELD AND ANY NEW FEE, LICENSE, USER FEE OR PERMIT WHICH INCREASES REVENUE SHALL BE INVALID ON AND AFTER THE NINETIETH DAY FOLLOWING THE ADOPTION OF THIS AMENDMENT UNLESS AND UNTIL APPROVED AS HEREIN PROVIDED.

"NO POLITICAL SUBDIVISION OF THE STATE, AFTER THE ADOPTION OF THIS AMENDMENT, SHALL IMPOSE OR LEVY ANY TAX ON INCOME UPON NON-RESIDENTS IN EXCESS OF 1/2 OF 1%.

"IF ANY PART, CLAUSE OR PHRASE HEREOF IS FOR ANY REASON HELD TO BE INVALID OR UNCONSTITUTIONAL, THE REMAING PART SHALL NOT BE AFFECTED BUT WILL REMAIN IN FULL FORCE AND EFFECT."

- Limit nonresident city income taxes to 1/2 of 1%.
- Require that tax proposals submitted to voters state the purpose of the tax, its anticipated revenue, and its date of expiration.

Comparison with Limitations in California and Massachusetts

Two well-known limitation proposals adopted by other states are Proposition 13 in California and Proposition 2½ in Massachusetts. California's Proposition 13 limited only individual property tax assessment increases to 2% per year and allowed only a 1% tax rate on property. Despite predictions that Proposition 13 would lead to massive cuts in government budgets and payrolls, local government spending was not severely reduced following passage of the proposal. At the time Proposition 13 was passed, California had a state budget surplus of more than $3 billion; this surplus was used to increase state aid to local units of government by funding state assumption of certain local functions such as education and police and fire protection. In addition, the use of reserves from earlier years and an increase in local sales tax revenue and user charges, combined with cost savings from a local government employee wage freeze, helped offset the potentially devastating impact Proposition 13 could have had at the local government level.

These actions facilitated a smooth adjustment to lower levels of government revenues and services. However, California's Silicon Valley continued to attract new business and stimulate rapid economic growth in the state. By the time budget reserves had been exhausted, there were enough new firms conducting business and paying taxes in California to more than compensate for the revenue losses imposed by Proposition 13.

In Massachusetts, Proposition 2½ dealt only with property taxes, limiting them to 2.5% of a property's actual market value. Passage caused immediate layoffs and budget cuts at both the state and local levels, including several thousand teachers and hundreds of firefighters. Massachusetts' state government diverted to local government a larger share of state lottery proceeds and authorized communities to raise fees to cover payment deficiencies stemming from the loss of property tax revenues. Fortuitously, Massachusetts, at that time, was being flooded with new high-technology businesses. Harvard and the Massachusetts Institute of Technology were emerging as research leaders in new high-tech fields. Research contracts at these universities infused millions of dollars into Massachusetts' economy and also attracted high-tech businesses to the state. This led to substantial increases in total business activity. The resulting gains in employment and economic activity generated enough revenue to offset the losses imposed by lower property tax rates.

Proposal C differs significantly from both the California and Massachusetts propositions.

While Propositions 13 and 2½ dealt exclusively with property taxes, Proposal C covers all taxes and a wide range of fees at all levels of government. Instead of presenting a taxation question to voters on one occasion for their approval, Proposal C requires continuing referenda on a wide variety of complex tax-related matters. The ongoing election costs to state and local governing units -- and subsequently to the taxpayers -- could contribute additional financial burdens. For instance, the total cost of each statewide election is $4.5 million. Proposal C could increase the frequency of referenda, forcing governing units to divert funds from other purposes to pay for elections.

In the other two states, the proposals permitted a shift of the tax burden from the property tax to other taxes such as sales or income taxes. Proposal C also permits such a shift, but only with the approval of the electorate. This provision presents the probability that, if additional revenue is required to sustain needed programs, voters might choose to vote "no" on direct personal, property, or consumption taxes, but vote "yes" on more indirect taxes such as those on business. If this were to happen, it would become more costly to conduct business in Michigan, thereby accelerating the departure of some Michigan businesses and discouraging the startup of new enterprises. In either case, Michigan, unlike California and Massachusetts, could lose, not gain, jobs, economic activity, and tax revenue.

It should be kept in mind that Michigan's fiscal and economic climate differs materially from that of California and Massachusetts. Michigan concluded its 1983-84 fiscal year with an estimated $264 million surplus, its first true budget surplus in more than five years. Michigan does not have sufficient reserves, as California did with a $3 billion surplus, to continue state programs at existing levels or to assume a portion of the responsibilities currently shouldered by local units of government.

In addition, Michigan has no new growth industries to fall back on for job creation and new business activity. In fact, Michigan's economy is one of the least diversified and most cyclical in the nation. Almost two years after the recession's end, Michigan employment still is only 3.85 million, 53,000 less than in 1978, the peak of the last business cycle.

Revenue Impacts of Passage

If Proposal C passes, its actual dollar impact to government will depend on what taxes are ruled to be subject to rollback and how many of the tax increases enacted since December 31, 1981, are subsequently reapproved by voters. However, Citizens Research Council of Michigan estimates that if none of the tax increases are reinstated, the loss to Michigan's General Fund would be $689 million in the remaining months of the 1984-85 fiscal year and $1,036 million on an annualized basis. These figures do not include unemployment compensation payments, but if payments to the unemployment compensation fund were ruled to be taxes for the purposes of Proposal C, there would be an additional loss of $357 million annually, bringing the total annual revenue loss to $1,393 million. The distribution of these losses is shown in the following table.

Estimated State Tax Revenue Subject to Rollback under Proposal C
(millions of dollars)

Tax	Fund(s)/Purpose	FY 1984-85	Annualized
Personal Income	General Fund	$287	$430
	SAFRA [a]	123	185
Cigarette	WCRA [b]	77	116
Sales	General Fund	11	16
	School Aid	36	54
	Local Units	9	14
	Transportation	4	6
Motor Fuel	Transportation	97	147
Motor Weights	Transportation	45	68
Unemployment Comp.	MESC [c]	--	357
TOTAL		$689	$1,393

[a] The State Accounting and Fiscal Responsibility Account (SAFRA) receives 0.25 percentage points of the income tax; this revenue is reserved for the express purpose of paying off accumlated state debt arising from the use of unacceptable accounting practices.

[b] Working Capital Reserve Account.

[c] Michigan Employment Security Commission.

SOURCE: Citizens Research Council of Michigan, May 1984.

If unemployment compensation payments were construed as taxes and the 1982 revisions were not ratified by voters, the loss of revenue would subject Michigan to federal penalties. Since 1979, unemployment benefits paid out in Michigan have exceeded the contributions paid into the unemployment compensation fund. To continue to pay benefits, Michigan's unemployment compensation fund borrowed more than $2.2 billion from the federal government. Federal law imposes a penalty tax of up to 2.7% on employers in states in which the unemployment compensation fund has been in deficit for five or more consecutive years. After April 1, 1982, the federal government also began charging 10% interest on new borrowings. In exchange for accelerated repayment of its debt, Michigan persuaded the federal government to waive interest charges. Public Act 535 of 1982 increased business contributions to the unemployment compensation fund to achieve this repayment and avoid a penalty tax.

However, because the increased contributions were imposed after December 1981, they may be subject to rollback under Proposal C. If the contribution rates were rolled back to 1981 levels, Michigan would be judged as defaulting on its loan payments; Michigan businesses would incur new federal penalty taxes of $500 million to $1 billion annually, plus 10% interest. Federal law prohibits making interest payments from the unemployment compensation fund, so state government would be forced to pay $109 million in deferred interest and $25 million annually in debt service on unemployment fund loans. This would further restrict the pool of funds available to support other government programs.

Passage of Proposal C also would affect federal revenue sharing. For instance, revenue from the federal gasoline tax is returned to states on the basis of their relative tax efforts. If Michigan's gasoline tax were rolled back to the 1981 level, the state would lose approximately $318 million in federal gasoline taxes as well as $147 million annually in state gasoline taxes.

Local units of government also would be affected: first by direct revenue losses stemming from the rollbacks and second by potential reductions in state grants and matching federal funds. Grand Rapids estimates that it would lose $1.1 million in property tax revenues and fees during the 1984-85 fiscal year and $4.2 million in fiscal year 1985-86. Kalamazoo projects its 1984-85 revenue loss at $3.1 million; Lansing's loss would be $6.3 million; and Southfield stands to lose $2.9 million. Detroit and Highland Park, the only two Michigan cities that impose a nonresident income tax of more than ½ of 1%, would lose a combined $40 million in income tax revenues alone.

Revenue losses of this magnitude would increase pressures on state government to help offset a portion of the loss. With fewer total resources available to meet the needs of local units of government, the state would be unable to satisfy these requests. However, funds returned to local units of government might be reallocated, with a greater percentage going to units with the most critical needs. This would almost certainly mean that Wayne County, with 25% of the state's total population, would have its share of state aid funds increased. Consequently, proportionately fewer state dollars would be available for other units. This would compound the difficulties of outstate units of government.

State Treasurer Robert Bowman estimates the costs of Proposal C would be even higher, possibly costing state government $927 million during fiscal year 1984-85, part of which would have gone to local units of government, plus $600 million in direct revenue loss to local government.

Spending Impacts of Passage

By statute, much of the revenue collected by state government is dedicated to specific purposes such as transportation and school aid and is not available to support other programs. Of the state's $12.3 billion budget, only 44% or

$5.4 billion is available for spending on discretionary items such as community colleges and universities, environmental protection, public and mental health programs, prisons, and public safety. While many people are dissatisfied with the amount of taxes they pay, most strongly support these programs. Proposal C would severely reduce the financial flexibility required to adequately meet these disparate needs.

The consequences would be felt in many other ways. Under the state constitution, the power to tax for the payment of principal and interest on bonds is unlimited as to rate or amount. This power would be limited by Proposal C. Thus, while the state and local units of government would still be able to borrow, their ability to repay would no longer be assured. This would increase the risk on loans to Michigan governmental units, a risk which would be reflected in premium interest rates on borrowing. The mere presence of Proposal C on the November ballot has caused concern in the credit markets and impaired Michigan's ability to borrow. Proposal C has already cost the state $1.8 million in additional risk premiums for its current short-term borrowings. Higher interest rates would increase debt service, further reducing the financial resources available to fund other existing or future programs.

Proposal C could also impair state and local governmental ability to qualify for federal matching funds. To qualify for a federal match, the unit of government applying for the match must be able to demonstrate it can provide its share of the total program or project cost. Proposal C could remove revenues needed to guarantee local funding and hamper efforts to provide these funds through taxation measures or bond sales. Thus, the total funding impact on particular programs could be many times the dollar amount the state or local unit itself would have invested in the project or program. Programs most vulnerable to this type of reduction in funding include toxic waste cleanup, major highway construction and renovation, public transit, and public assistance.

Implementing Proposal C

Putting aside the merits or liabili[illegible] of Proposal C, a serious problem is that the amendment fails to specify what is meant by its key provisions. This would make the process of implementation extremely difficult and could lead to a long and expensive period of litigation. Major questions include:

What constitutes a "legislative" change in the base or rate of a tax? For instance, since the state gasoline tax is tied to the highway cost index, a raise in the index triggers an automatic increase in the gasoline tax. Would this be construed as a "legislative" change?

If the federal government revises its definition of adjusted gross income in a way that would reduce state income tax collection, would the proposal prohibit the state from revising its definition of adjusted gross income so as to simply maintain (not increase) state income tax collections?

Would the first use of a previously authorized tax be considered a "new" tax? For instance, if a county chooses to exercise its authority to levy an unused but previously approved millage or tax, would this be a "new" tax?

Would tax credits be considered as part of the tax base or could additional funds be generated by eliminating some or all of the numerous tax credits? Elimination of the homestead property tax credit alone would increase state revenues by more than $580 million a year.

What is a "fee"? Would it include a special assessment for a local sewage line? Would it also include college tuition fees, state park use fees, hunting licenses, and occupational licensing fees? If a fee levy were submitted for a vote by the electorate, who would be eligible to vote? All voters in the state? All taxpayers in the affected locale? Only individuals whose tax rates/payment schedules wo[illegible] be directly reinstated or increased?

Many fees are not set by a legislative body. For example, the Commissioner of Financial Institutions sets bank examiner fees. Obviously, the required 4/5 vote stipulation would be impossible to carry out in this instance. In addition, many fees are variable and change automatically to keep pace with increases in actual costs and do not now require legislative review. Examples include soil test fees by county extension services and municipal golf course fees. Would increases in such fees require, under the proposed amendment, legislative review? What would happen to these fees during a period of litigation? If similar cases serve as precedent, the governmental unit would continue to collect the revenue but would place it in a separate escrow account pending a court decision. This would do nothing to ameliorate the concerns of those on either side of the issue, since taxpayers would continue to pay and government would be prohibited from spending the tax revenue.

Forecasting Revenue Yield

Proposal C requires that each tax proposal submitted to voters specify the anticipated tax revenue yield and the date of expiration. Such a requirement implicitly assumes that forecasting is a precise science. It is not. Experts, considering identical data, frequently arrive at conflicting conclusions because of assumptions and experiences each brought to the situations. Whose interpretation, if any, is correct can only be determined after the fact.

This could create another major problem in implementing Proposal C. If every tax proposal submitted to voters must state its total anticipated revenue, what authority or agency is to determine the amount of the total anticipated revenue? What happens if more or less revenue is raised than anticipated?

In a statement of estimated revenue yield, should the projection be for the remainder of the fiscal year in which the tax would first be imposed? Or for the first full fiscal year of the tax? Or for the lifetime of the tax? If estimated revenue is to be calculated for the lifetime of the tax, what economic and demographic assumptions should be used to provide the dollar yield for each year of the tax? Rather than using nominal dollar estimates, should revenue be projected using a specified base year and eliminating the fluctuations caused by inflation or by business cycles? Who will decide? It is likely that these questions, too, ultimately will be answered in court.

Lifetime yield calculations could become hopelessly complex as projections must be made for more and more distant points in the future. Proposal C specifies no limitation on the length of the period a tax could be levied, only that a date of expiration be identified. While the intent of this provision is undoubtedly to restrict the lifetime of any tax, there is no reason why an element of permanency could not be incorporated by specifying an extremely distant expiration date. Yield calculations for very extended periods of time would be meaningless.

Possible Constitutional Conflicts

By requiring that each tax proposal state the purpose for which the funds are to be used, Proposal C invites earmarking of all revenue sources. This could generate a conflict with Article II, Section 9 of the constitution which prohibits referenda for acts "making appropriations for state institutions or to meet deficiencies in state funds." That is, the proposal might have the effect of submitting all or a portion of the state budget to the voters, a violation of current constitutional provisions that ultimately would have to be resolved in the courts.

The proposal's language prohibits a revenue yield increase resulting from a change in the tax base. The definition of "change" is ambiguous. Article IX, Section 31 of the constitution requires that if a unit of local government broadens the base of an existing tax, the tax rate must be reduced so as to yield the same number of dollars provided by the previous base, exclusive of the value of new construction and improvements. Proposal C incorporates no such exclusion. This creates the possibility that taxation of new development might be construed as an expansion of the tax base and hence be subject to voter approval. This conflict with existing provisions of the constitution also would have to be resolved by the courts.

Other Implications and Considerations

Proposal C could effectively change our present representative democracy to a direct democracy in matters dealing with taxation and fee assessment. In a society as large and complex as ours, direct democracy is not feasible. Seldom, except for presidential elections, does a clear majority of Michigan's voting-age population actually go to the polls. Thus, the contention that Proposal C would cause taxation matters to be decided by the majority of Michigan's citizens is a fraud on the public.

By requiring a 4/5 majority vote of the adopting legislative body for any increase in licenses, permits, and fees, Proposal C increases the leveraging power of special interests. The potential for vote-trading is greatly enhanced.

By increasing the period of time before action could be taken, the proposed amendment also would impair government's power to deal with impending fiscal crises. A minimum of 53 days required to arrange and implement the results of a special election. Six months is more typical. In many cases, the situation could deteriorate so rapidly that the solution, by the time it was approved, might no longer be adequate. This proposal makes no provision for declaring a state of emergency. In practical terms, this would increase government's initial reliance on short-term borrowing. However, considering the likelihood of repayment, additional short-term borrowing could become prohibitively expensive or impossible at any cost.

Our system of government is made up of three branches: a legislative body to set policy and make laws, a judicial body to interpret laws, and an executive body to implement laws. Proposal C attempts to wrest from the legislative body the power to set tax policy and to transfer that power to voters. However, because Proposal C fails to clarify kev provisions in the amendment, ultimately would be left to the courts to determine what the amendment means and how it would be implemented. Thus, Proposal C would not necessarily return policy determination to the voters. Rather, it merely would effect a transfer of policy-making power from the legislative to the judicial body.

Conclusion

We believe that Proposal C is fundamentally flawed. The chaos it would visit upon government services and institutions; the damage it could impose on Michigan's economy, business climate, and job market; and the increased tax burden it might impose on the poor and elderly by creating incentives to eliminate tax credits make it apparent that the well-being and future of this state will best be served by the rejection of the superficial, overly simplistic solutions presented by Proposal C.