Income Tax: State Rate, Credits, and Deductions

BACKGROUND

When enacted in 1967, the Michigan income tax rates were set at 2.6 percent for individuals and 5.6 percent for corporations. Today the individual rate is 4.4 percent, and the corporate income tax has been repealed and replaced by the single business tax (SBT).

The base of the individual tax is federal adjusted gross income—with certain subtractions—for individuals, estates, and trusts. Adjustments allowed are (1) interest income from federal government obligations, (2) armed forces compensation, (3) retirement or pension benefits, and (4) since 1974, certain political contributions. Neither standard nor itemized deductions are allowed, and Michigan is not among the nine states that permit full or partial deduction of federal income taxes paid. The 1967 act provided a $1,200 personal exemption for individuals and credits for homestead property tax, city income tax, and taxes paid to other states. Later, an expanded homestead property tax credit, a home heating credit, and a credit for contributions to Michigan colleges, universities, public broadcast stations, community foundations, and public libraries were added as were several smaller credits. Individuals living in renaissance zones are exempt from the personal income tax, regardless of where they earn the income.

Michigan is one of only seven states without a standard deduction, but state residents do benefit from a generous personal exemption, now $2,800 (1998 tax year), for each filer and dependent. Of the 30 states that provide a personal exemption, in only three is the exemption more generous than in Michigan. (In Louisiana, for example, the exemption is $4,500 and $9,000 for single and joint filers, respectively, which is considerably higher than Michigan's; but for dependents, Louisiana allows only $1,000 each, which is much lower than in Michigan.) Six states offer a tax credit in lieu of a personal exemption, but none has a higher effective exemption than Michigan.

The personal income tax is Michigan's largest state revenue source, yielding $6.4 billion in revenue in FY 1996–97, almost 22 percent of state tax revenue. The personal income tax's share of total state taxes has fallen from about 40 percent in FY 1992–93 due to school finance reform, which replaced local school property taxes with state taxes. Exhibit 1 presents these data (the latest available), along with net collections, the year-to-year change in collections, and the *nominal* (actual) tax rate for each year. Nationwide, the personal income tax accounts for 31.5 percent of all

GLOSSARY

Effective tax rate
Calculated by dividing actual tax paid by adjusted gross income; the effective rate always is lower than the actual rate because of credits, exemptions, and deductions.

Elasticity
Extent to which a tax's revenue grows in response to inflation and economic growth.

Flat income tax
Uniform rate that all taxpayers pay on income.

Graduated income tax
Rate that increases as income rises.

Marginal tax rate
The tax rate paid on an extra dollar of income. For example, if the tax rate on taxable income over $30,000 is 20 percent, the tax on each $1 more than $30,000 will be 20 cents.

Progressivity
Extent to which a levy imposes a larger relative burden on people with high income than it does on people with low income.

Tax credit
Permits taxpayers to subtract specified sums from their tax liability; a credit is applied after final *taxable income has been calculated.*

Tax deduction
Permits taxpayers to subtract specified expenditures from taxable income; a deduction is applied before *final taxable income has been calculated.*

Tax exemption
Permits taxpayers to subtract from their taxable income certain specified sums on a per capita basis.

EXHIBIT 1. Michigan Personal Income Tax Collections (net of credits), FY 1977–78 through FY 1996–97

Fiscal Year	*Amount (millions)*	*Percentage Change*	*Percentage of Total State Taxes*	*Nominal Tax Rate*
1977–78	$1,712.4	16.9%	31.9%	4.60%
1978–79	1,943.5	13.5	32.4	4.60
1979–80	1,912.1	–1.6	31.3	4.60
1980–81	2,036.0	6.5	32.8	4.60
1981–82	2,289.7	12.5	35.2	5.10
1982–83	2,766.4	20.8	38.4	6.35
1983–84	3,255.6	17.7	38.4	5.85
1984–85	3,241.4	–0.4	36.4	5.33
1985–86	3,151.8	–2.8	34.0	4.60
1986–87	3,350.3	6.3	34.9	4.60
1987–88	3,573.9	6.7	34.9	4.60
1988–89	3,766.2	5.4	34.7	4.60
1989–90	3,907.7	3.8	35.3	4.60
1990–91	4,667.1	19.4	39.8	4.60
1991–92	4,892.6	4.8	40.0	4.60
1992–93	5,180.0	5.9	40.3	4.60
1993–94	5,529.1	6.7	36.7	4.60
1994–95	5,473.1	–1.0	31.3	4.40
1995–96	5,868.4	7.2	31.7	4.40
1996–97	6,400.4	9.1	32.9	4.40

SOURCES: Calculations by Public Sector Consultants, Inc., from data contained in (1) Senate Fiscal Agency, December 1991 and 1997 statistical reports, *and (2) Michigan Department of Treasury,* Analysis of the Michigan Individual Income Tax for 1994, *September 1996.*
NOTE: The percentage changes between FY 1981–82 and FY 1985–86 are distorted by changes in rate and federal tax policy. Between tax years 1982 and 1986, the base of the tax (adjusted gross income) changed –0.6 percent, 3.6 percent, 8 percent, and 12.4 percent, respectively. The large jump from FY 1989–90 to FY 1990–91 was the result of a change in the method of accounting for property tax credits. Adjusted gross income increased only 2.8 percent from tax year 1989 to tax year 1990.

state tax revenue (1994 data). Only eight states do not levy a broad-based state income tax (Connecticut is the most recent to do so, in 1991, the first since New Jersey, in 1976).

The distribution of the income tax revenue has changed in recent years. Until 1994 a small share of the revenue—about 6 percent—was distributed to local units of government; the remainder was distributed to the state General Fund. As a result of school finance reform, 23 percent of the tax now goes to the School Aid Fund and the remainder to the General Fund. Due to a 1997 change in the revenue-sharing formula, none of the income tax is distributed to local governments.

DISCUSSION

Michigan is one of only four states levying a flat rate on earned income; that is, all taxpayers pay the same rate—currently 4.6 percent in Michigan—on their income. In many of the 38 states that levy a *graduated* rate, however, the graduation is minimal: the rate range is narrow, or the income level at which maximum rates take effect is low. In Maryland, for example, income tax rates range from 2–5 percent, but at income over $3,000, the maximum rate applies. The Michigan Constitution prohibits a graduated rate, and three attempts to repeal this prohibition have been defeated soundly by voters.

At one time most state/local tax experts favored a graduated state income tax, but thinking has changed in recent years. High tax rates at higher income levels now generally are viewed as detrimental to economic growth because they discourage saving and may reduce the incentive to work. A high *marginal* rate also is viewed as detrimental to the business climate; for this reason, in recent years such states as

Minnesota and New York have reduced their top rate. The high *elasticity* (growth in revenue in response to inflation and economic growth) of the graduated income tax no longer is considered a clear advantage, because it can permit excessive increases in government spending; current thinking is that revenue growth should not outpace economic growth.

Supporters of a graduated income tax argue first that it is fairer than a flat rate because it requires a larger relative contribution from those with a greater ability to pay. They reason that people with higher income have more discretionary income than do people with lower income and, therefore, the former can afford to pay more taxes. Second, since a graduated income tax is more responsive to economic growth, it makes government revenue grow faster and there is less need for periodic increases in tax rates. Third, the graduated tax has an advantage for federal income taxpayers in the higher brackets, because the amount of his/her state income tax that a taxpayer may deduct is larger under a graduated than a flat rate. (The 1986 Federal Tax Reform Act reduced this benefit by lowering marginal rates and restricting who may itemize deductions.)

Although the Michigan income tax has a flat rate, it is *progressive* (imposes a larger relative burden on higher income taxpayers), particularly at lower income levels, due to the generous personal exemptions and credits. A large personal exemption increases the progressivity and the growth potential of the tax. The rise in the exemption from $1,500 to $2,100 in 1990 increased its elasticity from an estimated 1.15 to 1.23. (An elasticity of 1.23 means that the revenue from the levy will rise 23 percent faster than the increase in personal income.) Subsequent increases in the personal exemption have further raised the elasticity, but no recent estimates have been made. Exhibit 2 shows the effective tax rate for a various income levels: It is negative at the lowest because of property tax credits, but the credits and exemptions become less significant as income rises, resulting in little progressivity above $20,000 in adjusted gross income.

Governor Engler has recommended reducing the personal income tax rate 0.1 percent annually for five years, beginning in FY 1999–2000, which ultimately would lower the rate to 3.9 percent. Legislators have introduced bills to allow credits/deductions/exemptions having to do with child care, dependent care, crime-proofing one's home, contributions to certain children's programs, tuition, long-term care insurance, earned income, and gratuities; many such proposals are made, but few find their way into law.

See also Child Care; Economic Development: State Financial Incentives; Headlee Amendment; Health Care Access; K–12 Schooling Alternatives; Long-Term and Related Care; University Funding; Urban Revitalization.

EXHIBIT 2. Effective Rates of Michigan Individual Income Tax, 1994 Tax Year

Adjusted Gross Income Class	Effective Rate
$.01–2,000	–7.6%
2,000.01–4,000	–1.6
4,000.01–6,000	–0.6
6,000.01–8,000	–0.2
8,000.01–10,000	0.4
10,000.01–12,000	0.9
12,000.01–14,000	1.3
14,000.01–16,000	1.7
16,000.01–18,000	2.0
18,000.01–20,000	2.3
20,000.01–22,000	2.4
22,000.01–24,000	2.5
24,000.01–26,000	2.7
26,000.01–28,000	2.8
28,000.01–30,000	2.9
30,000.01–35,000	3.1
35,000.01–40,000	3.2
40,000.01–45,000	3.4
45,000.01–50,000	3.5
50,000.01 and over	3.5
AVERAGE RATE	3.0%

SOURCE: Office of Revenue and Tax Analysis, Michigan Department of Treasury, September 1996.

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