January 2013

Pat Sorenson, Senior Policy Analyst

Losing Ground: A Call for Meaningful Tax Reform in Michigan

EXECUTIVE SUMMARY

THE BOTTOM LINE: MICHIGAN'S TAX SYSTEM IS OUTDATED AND NEEDS REFORM

Michigan's current tax system is broken and must be reformed. It cannot consistently raise the revenues needed to invest in Michigan's future, create economic growth and maintain needed public services. As the state's economy has struggled and evolved, its tax system has not kept pace. The result has been more than a decade of budget deficits and cuts, and an erosion of Michigan's competitive advantage in the national and global economies.

MICHIGAN FAMILIES ARE LOSING GROUND

Michiganians care about the quality of life in this state, and want to know that the next generation will enjoy a better standard of living than they did, or at the very least, not lose ground. The reality is that many Michigan families and workers are losing ground. Michigan is now 39th in the nation in per capita income, down from 18th in 2000, and poverty has jumped 66% in Michigan since 2001—the largest poverty increase in the country over a decade.

SHORTSIGHTED TAX POLICIES ARE TO BLAME

The stresses facing families are not solely caused by Michigan's sustained economic problems or the national Great Recession. State tax and spending policies adopted by Michigan lawmakers have made matters worse by closing budget gaps through cuts in the very services that could create opportunities for low-income families and children, as well as tax shifts that have penalized hardworking families by raising the effective tax rates of the lowest income earners.

Most recently, a major tax shift approved by the Michigan Legislature in 2011 made the state's tax system significantly more regressive by cutting business taxes by 83% while increasing taxes for individual taxpayers by 23%, with a net loss of state revenue. Low- and moderate-income families were hardest hit, as many of the credits and deductions intended to reduce their income tax burden were reduced or eliminated, most notably a 70% cut in the state Earned Income Tax Credit—a refundable tax credit that has been shown to lift children and families out of poverty, increase employment and reduce the need for public assistance.

The Legislature's rationale for this tax shift was that business tax cuts would increase the state's competitiveness, spurring

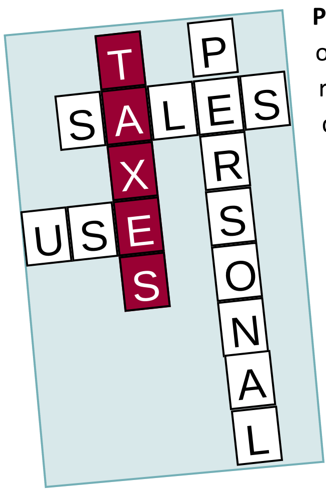
Even Prior to the 2011 Tax Shift, Low-Income Families Paid Higher Share of Income in State and Local Taxes

Source: Data from Institute for Tax and Economic Policy
Produced by Michigan League for Public Policy

economic and job growth—an assumption not supported by the evidence. The real result is growing income disparity in Michigan, where even before the 2011 tax shift, the lowest-income families in the state paid 9% of their household incomes on taxes, while the highest income families paid only 5.6%.

STATE REVENUES NEED REFORM

Michigan's total state budget—with revenues from all state and federal sources—is projected to be $46.9 billion this fiscal year. More than $4 out of every $10 spent by the state is from federal sources, and the percentage of federal funds is increasing. The other major sources of revenue for the state are sales and use taxes (18%) and the state's personal income tax (17%). Business taxes are expected to generate less than 2% of total state revenues this year.



Personal Income Tax: Michigan is one of only seven states with flat rate income taxes, and with the deep cut in the EITC and other tax credits, the inherently regressive flat tax is placing an ever greater burden on low- and moderate-income taxpayers.

Sales Tax: Michigan's sales tax was adopted in 1933, and doesn't reflect today's consumer and economy. The state's 6% sales tax rate hasn't been increased since 1994, and ranks (along with 4 other states) 11th lowest among the 45 states with a sales tax. Since the sales tax was adopted, consumer spending habits have changed dramatically, shifting from the purchase of goods, which are taxed in Michigan, to services, which largely are not. In 2007, Michigan taxed only 26 services, fewer than 38 states and the District of Columbia. The estimated loss of revenue due to the exemption of services was $10 billion in fiscal year 2010.

Use Tax: Also adopted in the 1930s, the state's use tax—a tax levied on items that are bought outside of Michigan for use in the state—has stood at 6% since 1994. With the dramatic shift to e-commerce and internet sales, the use tax is an increasingly important source of revenue, but Michigan relies largely on voluntary compliance by consumers, and approximately 1% of what is owed is actually collected. As a result, the total amount of revenue loss from catalog, e-commerce and remote sales is expected to grow to $451 million in the current fiscal year.

Business Taxes: Although Michigan has not traditionally been a high tax state for businesses, as a result of recent changes, two-thirds of Michigan business will not be subject to taxes—even though they clearly benefit from government services such as police and fire services. When fully phased in this year, Michigan's new Corporate Income Tax will create a revenue loss of roughly $1.6 billion, and will place Michigan at 47th in the nation in Corporate Income Tax revenue per capita—last among the states that levy a Corporate Income Tax.

AN AGENDA TO MOVE MICHIGAN FORWARD

The evidence is clear. Michigan's budget and revenue problems preceded the national Great Recession, and in the absence of tax reform, are likely to continue despite modest national and state economic recovery. Michigan must aggressively pursue tax reforms that modernize its outdated tax system to make it more fair and dependable, including the following:

- **Restore the Earned Income Tax Credit.** By putting money into the hands of low-income families, the EITC has the potential to raise more families out of poverty than any other tax policy. The EITC encourages work, as well as the likelihood that children will succeed in school and ultimately in the workplace—part of what Michigan needs to cultivate a highly skilled workforce.
- **Increase the rate of the new Corporate Income Tax.** Michigan cannot afford the revenues lost as a result of the tax shift of 2011 without further crippling the state's ability to build a world class educational system and provide the basic public services needed to ensure economic recovery and growth.
- **Modernize the states sales and use taxes.** Michigan needs to recognize current consumer spending habits by expanding the sales tax to selected services and establishing mechanisms to enforce the taxation of internet sales.
- **Scrutinize all forms of spending**, including tax expenditures, to ensure they contribute to economic and human capital development. Michigan lawmakers should establish a process to annually review tax expenditures (breaks), and eliminate those that no longer serve a useful public purpose. In addition, the state must make it a high priority to invest fully in the services that are fundamental to job and economic growth such as education, health, high quality early education, and basic income supports.