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# Losing Ground: A Call for Meaningful Tax Reform in Michigan

## THE BOTTOM LINE: MICHIGAN'S TAX SYSTEM IS OUTDATED AND NEEDS REFORM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

## WHAT MICHIGANIANS WANT

Michiganians agree on many things. We love our state's natural resources and Great Lakes, and want to see them protected. We want our children to have access to the top-notch public education needed to succeed in the state's evolving economy. We want well-maintained highways and convenient public transportation. We want our communities to be safe, with adequate police and fire protection. We want to be assured that the food and water we consume are safe. We want to know that we will be able to find the health care and other social services our families need to stay well and strong.

In short, Michiganians care about the quality of life in this state, and hope that they, their children and other loved ones will have the opportunity to succeed, enjoying the benefits of a clean environment, good schools, safe and supportive communities and a vibrant economy. They 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*.

## MICHIGAN FAMILIES ARE LOSING GROUND

The reality is that many Michigan families and workers are losing ground, and have come to believe that the next generation will be worse off, unable to find decent jobs with benefits, retire with security, find reasonably priced healthcare, or make sure that their children receive the high-quality education needed to compete in our knowledge-based economy. As unemployment and poverty have risen, state tax and spending policies have made problems 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.

**DID YOU KNOW?**

- General Fund revenue in 2010, adjusted for inflation, is 15.5% lower than in 1968.
- Newly reduced business income taxes are expected to generate less than 2% of total state revenue.
- The reduction in the state Earned Income Tax Credit means a $262 million tax hike to low-income working families.

**More families are struggling.** Over the last decade, Michigan families and workers have faced high unemployment, declines in their personal income and increasing poverty. These setbacks have been caused by a number of economic and policy changes including a national recession, the reshaping of the automobile industry, a dramatic shift from manufacturing jobs to lower-wage jobs in the services industry, and state policy decisions that have favored tax and budget cuts over investments in education and other public services needed to build human capital and attract and retain businesses.[1]

- ***Personal income is falling***: During the decade between 2000 and 2010, Michigan personal income increased only 17%, compared with a 44% increase nationwide, and the growth in personal income was the slowest in the nation.[2] Michigan is now 39th in the nation in per capita income, down from 18th in 2000.[3] Michigan median household income also fell dramatically, coming in at $45,981 in 2011, almost a 20% drop in inflation-adjusted dollars over the decade, with income inequality continuing to grow.

- ***Poverty is increasing***: The latest numbers show a 66% jump in poverty in Michigan since 2001, the largest poverty increase in the country over the decade. In addition, Michigan had the third-biggest growth, nearly 34%, in child poverty over the 10-year period.

**To balance the state budget, the Michigan Legislature made deep cuts in services or turned to one-time or short-term solutions—decisions that only further damaged the state's economic prospects.** For more than a decade, Michigan lawmakers responded to the mandate to balance the state budget each year by resorting to a series of one-time and short-term budget fixes, as well as deep cuts in services. Their decisions disproportionately affected low-income families and individuals, and particularly children, the state's next generation of workers and leaders.

**DEEP SPENDING CUTS OVER THE LAST DECADE HAVE TAKEN A TOLL**

- The state's public schools are grappling with large deficits and some are facing bankruptcy.
- Public assistance programs for families with children have been slashed, resulting in the loss of basic income assistance for thousands of children and families.
- Between 1990 and 2009, the number of state employees fell by nearly a quarter.[4]
- Michigan cities, townships and villages have suffered deep cuts in state revenue sharing, resulting in the postponement of capital projects such as street, sidewalk, sewer and water improvements; curtailment or elimination of recreation and library programs; and significant reductions in police and fire protection.[5]
- Programs to prevent child abuse and neglect have been cut as the number of confirmed cases of child maltreatment grew by 41% between 2000 and 2010.[6]
- State spending on higher education (from state resources) was reduced by over 29% between fiscal years 2003 and 2013, resulting in increases in tuition and cuts in student financial aid, and putting higher education, so important in building our next workforce, out of the reach of many.[7]
- Investments in Michigan's infrastructure, including its roads, are lagging, and state highway officials have forecast that within eight years, only 44% of the state's roads will be in good or fair shape. [8]

**Tax changes that were adopted did not serve to modernize the tax system to match current fiscal realities, and in many cases only increased budget gaps or made the state's tax system more regressive.** Over the last decade, many of the attempts to address the state's budget problems through revenue changes were temporary, or served to raise effective tax rates for low- and moderate-income taxpayers in order to reduce taxes for businesses and corporations.

## MODERNIZATION OF MICHIGAN'S TAX SYSTEM IS LONG OVERDUE

To increase their competitive advantage, some forward-thinking states have been working to modernize their tax systems, and *it is past time for Michigan to follow suit*. The budget gaps that resulted in more than a decade of cuts and stopgap measures in Michigan were not solely caused by the weakened state and national economies. The state's fiscal problems were also created or exacerbated by policy decisions that favored budget cuts over a more balanced approach that includes improvements in the state's revenue system to make it more fair, stable and adequate.

Michigan cannot continue to rely primarily on budget cuts during economic downturns without hurting the very infrastructures, institutions and services that help build the workforce of the future and make Michigan an attractive place to do business. *Michigan's current revenue system fails to meet two important principles for responsible tax policy:*

***Adequacy***—the state's tax system must raise enough funds to sustain the level of public services needed for long-term economic growth and quality of life in the state. To be adequate, the tax system must be stable, growing at a predictable rate, and able to weather the normal ups and downs of the state's economy.[9] Michigan's reliance on deep cuts in services over the last decade is evidence that the state's current revenue system cannot raise adequate funds to handle the cyclical changes in the economy.

***Fairness***—a fair tax system asks taxpayers to contribute to the cost of public services based on the ability to pay. Taxes are considered "progressive" when higher-income households pay a larger share of their incomes in taxes and "regressive" when lower-income households pay a larger share. Michigan's revenue system is largely regressive, and is moving in the wrong direction in terms of fairness.

## ENSURING ADEQUATE REVENUES FOR PUBLIC SERVICES: MICHIGAN'S FALLS SHORT

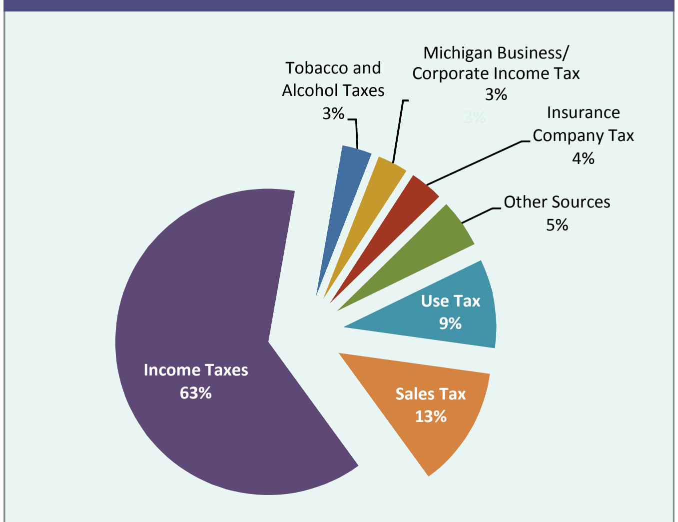
Over the last decade, as a result of *both* the state's economic problems and the Legislature's tax policy decisions, total state revenues (excluding federal funds), increased only modestly, and were not sufficient to cover the increased need for services related to the economic downturn, or allow for the strategic investments in education and human capital needed to create economic prosperity.

The majority of state taxes and fees are placed in the state's General Fund or state-restricted funds, including the School Aid Fund or various transportation funds.

***State General Funds***: State General Funds can be appropriated by the Legislature for a wide range of state services, and are often at the center of the budget debates each year. The state income tax is the major source of revenue for the state General Fund, representing two thirds (63%) of total funding. State sales and use taxes generate 22% of the General Fund, while business and insurance taxes bring in another nearly 7%.

***State Restricted Funds***: State restricted funds can be used only for certain specified purposes. The two largest state restricted funds are the School Aid Fund ($12.9 billion) and state transportation funds ($3.3 billion). The major sources of revenue for the State School Aid fund are sales and use taxes (44%), the income tax (17%), the state 6-mill education tax (14%), and federal funds (13%). The primary sources of transportation funds are federal funds (37%), licenses and permits (32%), and the state gasoline tax (25%).[10]

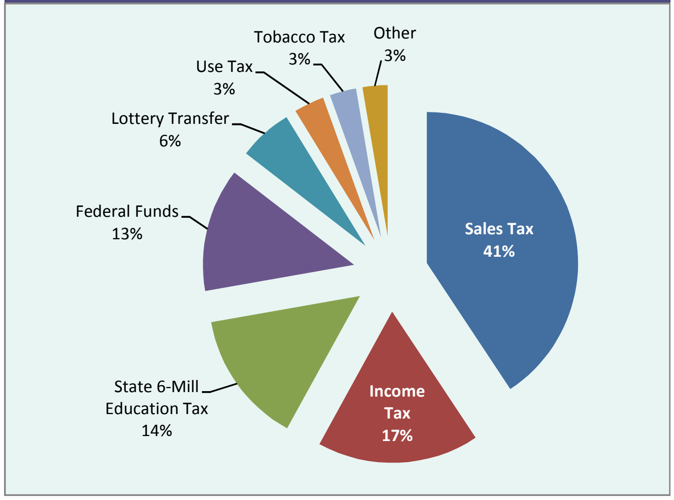
**Largest Source of Revenue for the State General Fund: Personal Income Taxes**
**FY 2012-13**




*Source: House Fiscal Agency*
Produced by Michigan League for Public Policy

Between 2000 and 2014, the state's General Fund/General Purpose (GF/GP) revenues are expected to fall by 13%, from $10.7 billion to $9.3 billion, while School Aid funds will grow by approximately 16%.[11] During that time, the cost of delivering services has been increasing, and growth in Medicaid and corrections costs has placed enormous pressure on other parts of the state budget.

**Largest Source of Revenue for the School Aid Fund: State Sales Tax**
**FY 2012-13**




*Source: Senate Fiscal Agency*
Produced by Michigan League for Public Policy

***Health Care Costs Expanded Rapidly***: Between September of 2004 and August of 2012, the number of Medicaid recipients grew by 74%.[12] In the decade between fiscal years 2003 and 2013, state spending for the Department Community Health is expected to jump by nearly 53%.[13]

***State Spending on Corrections Continued to Grow***: Between fiscal years 2003 and 2013, corrections spending in Michigan will rise by 20%.[14]

Insufficient revenue growth, along with the rise in Medicaid, corrections and other services costs, resulted in budget gaps and deep cuts in other state services and programs. In the decade between fiscal years 2003 and 2013, state funding for higher education is expected to fall 29%, while funding for the Department of Human Services will drop by nearly 9%.[15]

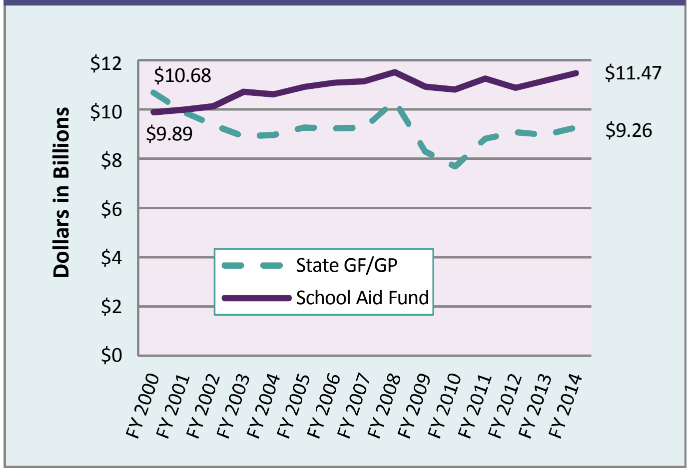
When adjusted for inflation, ongoing state General Fund revenue in fiscal year 2010 was *15.5% lower than the level in fiscal year 1968*, when the state adopted the new personal and corporate income taxes. Ongoing School Aid Fund revenues in fiscal year 2010, on an inflation-adjusted basis, were *6.4% lower than the level in fiscal year 1995 when Proposal A took effect*.[16]

## MAKING IT FAIR: MICHIGAN'S REVENUE SYSTEM WAS REGRESSIVE TO START WITH, AND IS MOVING IN THE WRONG DIRECTION

Tax reforms passed by the Michigan Legislature in 2011 made Michigan's tax system significantly more regressive by cutting business taxes while increasing taxes for individual taxpayers, including low- and moderate-income families. This big tax shift included:

**State School Aid Funds Expected to Rise While State General Funds (GF/GP) Drop**

**Fiscal Years 2000 – 2014**



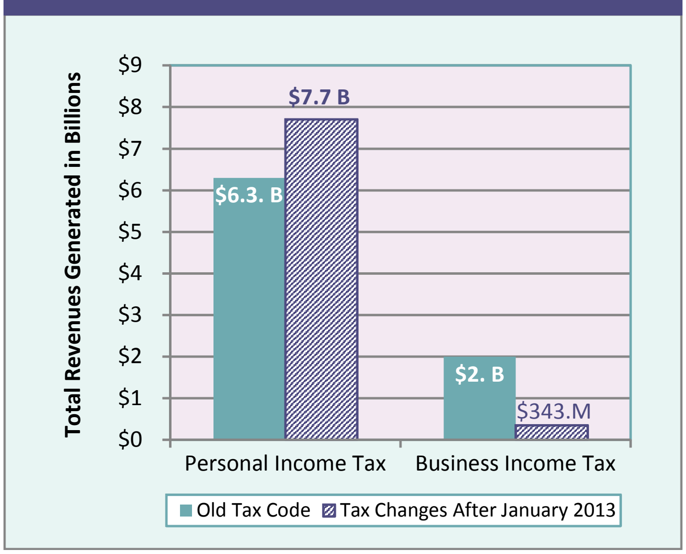

*Source: Senate Fiscal Agency*
Produced by Michigan League for Public Policy

***A cut in business taxes of 83%, or $1.6 billion**:* Beginning in January of this year, the Michigan Business Tax (MBT) was replaced with a flat 6% Corporate Income Tax on certain businesses. As a result, approximately two-thirds of all business will no longer have to file a state business tax return, and most businesses will enjoy a net tax reduction.

***An increase in taxes on individuals of 23%, or $1.4 billion***: The 2011 tax shift changed personal income taxes in a number of ways, but the overall effect was to increase taxes for individuals, and to make t he personal income tax more regressive in Michigan. As part of the tax overhaul, many of the income tax credits and exclusions that help to make Michigan's flat tax more progressive were reduced or eliminated, including a reduction in the Michigan Earned Income Tax Credit, modifications to the Homestead Property Tax Credit, and new taxes on pension income.

**Taxes on Individuals Skyrocket as State Revenues from Businesses Dwindle**

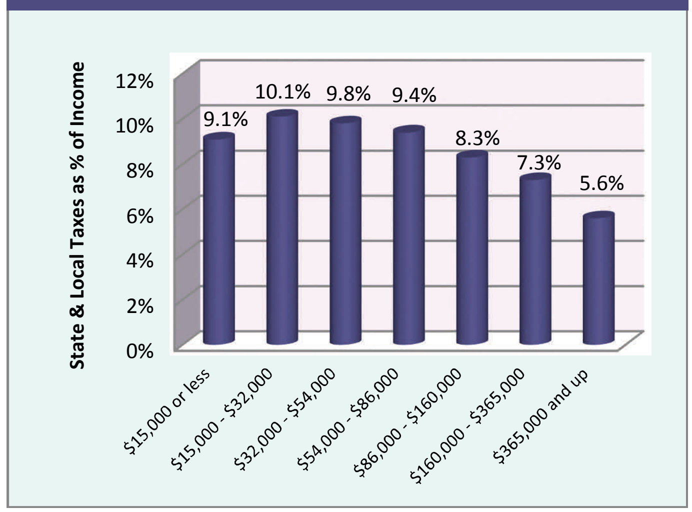
**Fiscal Year 2013**




*Source: House Fiscal Agency*
Produced by Michigan League for Public Policy

Even before the 2011 tax shift, low-income households in Michigan paid a disproportionate share of their income on state and local taxes. The lowest-income families in the state, with incomes below $15,000 in 2009, paid 9% of their household incomes on taxes. By contrast, the highest income families (with incomes above $365,000) paid only 5.6% of their income on taxes. With the reduction of the Earned Income Tax Credit and other credits targeted to low- and moderate income families, Michigan's tax system is destined to become even more regressive. [17]

**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

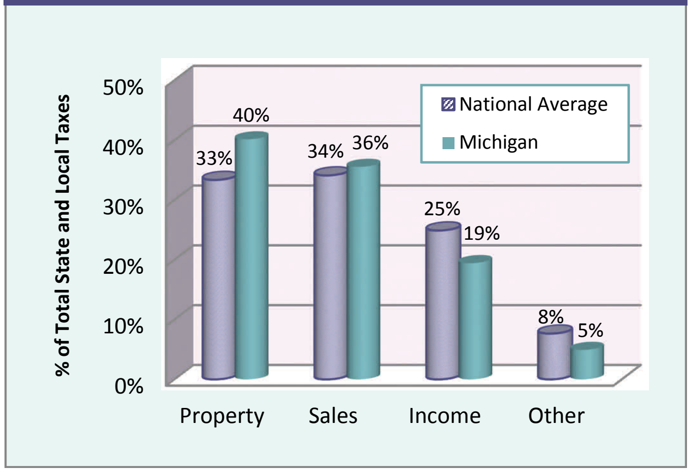
## A CLOSER LOOK AT MAJOR SOURCES OF REVENUE AND THE NEED FOR REFORM

### A Note on Local Revenues

In addition to the revenue sources for the state budget, which are the focus of this report, local units of government generate revenues for a broad range of vital public services. Approximately 75% of the funding for local governments comes from local property tax collections, with roughly 25% from unrestricted state revenue sharing. Both sources of revenue have declined in the face of increases in the costs and demand for local services.[18]

In 2012, an estimated $12.8 billion was collected in general local property taxes, with slightly over half traditionally being dedicated to school districts, intermediate school districts, and community colleges.[19] When looking at *state and local revenues combined*, Michigan has a relatively heavy reliance on property tax revenues, and ranked 29th in the country in total state and local tax revenues per capita in 2010.[20] In 2009, the share of total state and local taxes that were generated from the property tax was 40%, compared with 33% nationally.[21]

**Total State and Local Taxes: Michigan More Reliant on Property & Sales Tax**
**2009**




*Source: Citizens Research Council*
Produced by Michigan League for Public Policy

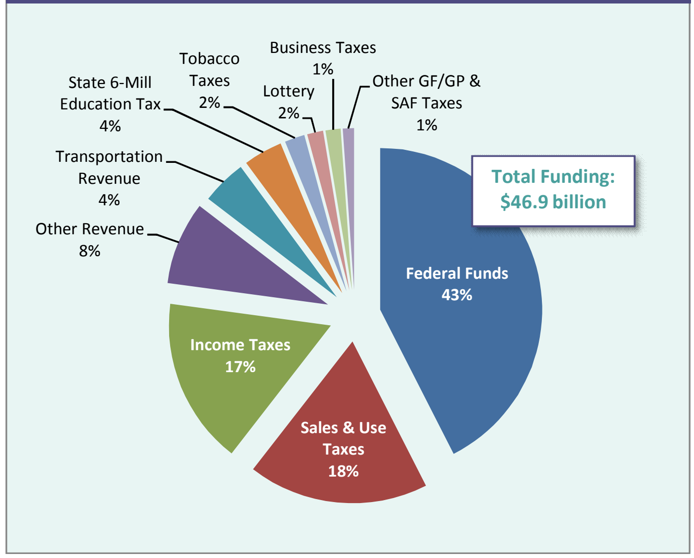
State revenue sharing to counties started on a small scale in 1933 and subsequently expanded with funding from a range of state taxes, including sales, income and business taxes. A significant portion of the state allocations to local governments are set in statute, but as a result of state budget cuts, the allocation formula has not been fully implemented. If fully funded, statutory revenue sharing payments to local governments in fiscal year 2011 would have been approximately $914 million, instead of the $416 million that was actually provided.[22] Further, less than one-third of the local governments that received statutory payments in the early 2000s receive them today, and funding to cities, villages and townships, which peaked at $684 million in fiscal year 2001, stands at $225 million in the current year budget—a 67% cut.[23]

Compounding the problem, local governments in Michigan have very limited authority to raise taxes. Local taxes vary by unit of government, but are subject to state limits, including property tax limits, requirements for voter approval to raise property tax rates, very limited local income tax options, and the inability to establish local sales taxes.[24]

## Sources of Revenue for State Programs

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. The other major sources of revenue 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.[25]

**Three Largest Sources of Revenue in Michigan Budget: Federal Funds, Sales & Use and Income Taxes**
**FY 2012-13**

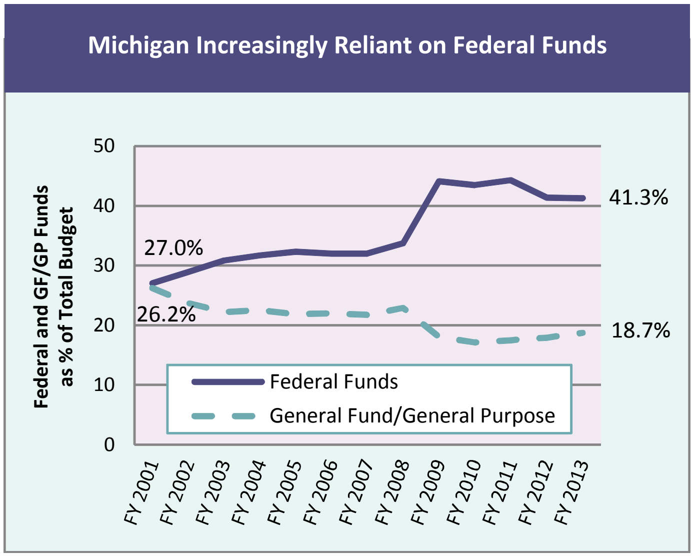



*Source: House Fiscal Agency*
Produced by Michigan League for Public Policy

***Federal Funding*: Federal funding is increasingly important in balancing Michigan's budget, so any decisions by Congress to reduce the federal deficit through deep cuts place many state services at risk.** The single largest revenue source for Michigan's budget is federal funding, and the state's reliance on federal funding is growing. The percentage of state expenditures paid for with federal dollars jumped by almost 53% between fiscal years 2001 and 2013, while state General Fund/General Purpose dollars (GF/GP) fell as a share of the total state budget by approximately 29%.[26]

Should Michigan lose significant federal dollars as a result of the inability of Congress to agree to an alternative to sequestration (automatic across-the-board cuts for the next decade), unprecedented state-level cuts will be required. With nearly $20 billion in federal funds expected in fiscal year 2013, under sequestration, Michigan could lose $861 million in federal funding in fiscal year 2013 alone.

***The Personal Income Tax*: Michigan has a flat rate personal income tax that is becoming even more regressive.** Michigan's personal income tax was first adopted in 1967, and while the rate has been adjusted both up and down over the years, it remains a "flat tax," meaning that all taxable income is taxed at the same rate, which is currently 4.35%. As part of the tax changes approved by the Michigan Legislature last year, the




*Source: Senate Fiscal Agency*
Produced by Michigan League for Public Policy

state's income tax rate will be reduced to 4.25% in January of 2013, and will be frozen at that level.

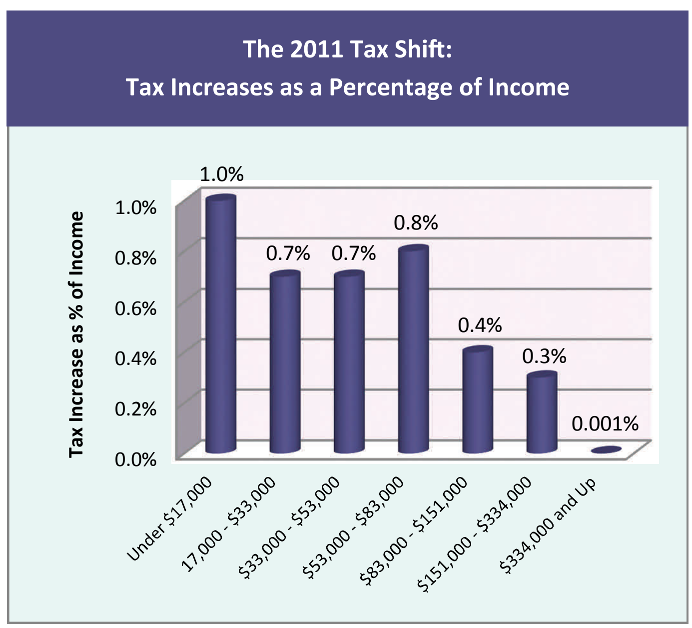
Michigan is one of only seven states with flat rate taxes for personal income.[27] While on the surface flat rate income taxes may appear to be fair, they are in fact very regressive because the percentage paid by low- and moderate-income taxpayers represents a greater share of their disposable income. Michigan's flat rate tax also doesn't reflect the reality that the state's income growth is increasingly concentrated in high-income families. Between 1970 and 2010, income inequality in Michigan grew more than the rest of the nation, with Michigan's top 5% experiencing income growth of nearly 61%, compared to the national average of 56%. In fact, Michigan's growth in income inequality was faster than in all but seven states between 1979 and 2009.[28]

Further, with the tax shift approved by Michigan lawmakers in 2011, credits and deductions intended to reduce the income tax burden on low-income families were lost, the most significant being the Michigan Earned Income Tax Credit (EITC) and the Homestead Property Tax Credit (HPTC). The net result is that when the changes are fully implemented in 2013, the lowest-income taxpayers (with incomes of less than $17,000) will face the largest tax increases, equaling approximately 1% of their incomes, while the top earners ($334,000 and more) will see an increase of only .001% of income.[29]

***EITC* cut by 70%:** Just five years ago, Michigan was one of just five states that taxed working families of four earning less than $14,000, or approximately 71% of the federal poverty level. In 2009, state lawmakers approved the EITC, which greatly reduced the state's heavy taxation of low-income families. Michigan's EITC, like many others states, is linked to the federal EITC, and is established as a percentage of the federal credit. Set at 10% phasing up to 20% of the federal credit when adopted, Michigan's EITC is only available to working families and is partially "refundable," meaning that the credit is available to families with little or no state income tax liability, and is provided as a refund if the credit amount exceeds income tax liability.

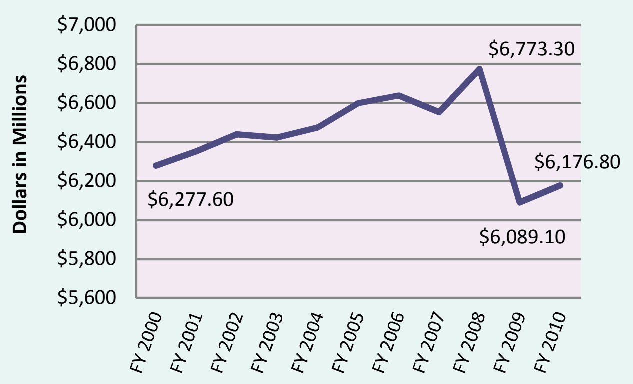
During deliberations over the fiscal year 2012 budget, the governor proposed to eliminate the state EITC, which was providing an estimated $338 million in credits to low-income working families in 2009. A final hour agreement with lawmakers reduced the state EITC from 20% of the federal credit to 6% at an estimated cost of $112.1 million, a cut of 70%. As a result, beginning in 2013, an estimated 782,600 low-income families will see their EITC drop from $432 to $143. Further, Michigan's tax threshold for a two-parent family of four will be reduced from its current level of 34% above the poverty line to slightly below the poverty line, and the taxes of two-parent families at the poverty line will be increased by $678.[30] The bottom line: An increase of $261.6 million in taxes on low-income working families.[31]

***Fewer families will benefit from the Homestead Property Tax Credit:*** The HPTC provides property tax relief for moderate-income families, seniors and the disabled. Prior to tax changes in 2011, the refundable credit was 60% of the amount that property taxes exceeded 3.5% of income (20% for rent), and 100% for seniors and the disabled—with a maximum credit of $1,200. With the tax shift of 2011, nearly 270,000 middle-income families will lose the credit entirely, while seniors with household resources over $21,000 annually will receive progressively lower credits. The bottom line: An increase of $270.2 million in taxes paid by individuals beginning in 2013.[32]




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

**Sales Tax Revenue Dropped by 10% During Great Recession**




*Source: Michigan Department of Treasury*
Produced by Michigan League for Public Policy

***Sales and use taxes:* Michigan's sales and use taxes are outdated and fail to reflect consumers' greater reliance on services and e-commerce.**

***Sales tax**:* Michigan's sales tax was first adopted in 1933 at a rate of 3%, and was not increased until 1960, when it was raised to 4%. As part of the adoption of Proposal A in 1994—which reformed how K-12 education is financed in Michigan—the maximum sales tax rate was increased to 6%, where it remains today. Michigan's 6% sales tax rate ranks it (along with 4 other states) 11th lowest among the 45 states with a sales tax.[33] In the current fiscal year, most Michigan sales tax revenue will be dedicated to the state School Aid Fund (72.7%), the state General Fund (15.8%) and local government revenue sharing (10.1%).[34]

Even with a 1974 Constitutional amendment to eliminate sales and use taxes on food and prescription drugs, Michigan's sales tax is regressive because low-income residents pay substantially more in sales tax as a share of their income than do higher-income taxpayers. In fact, sales taxes make up 60% of low-income families' total tax bills.[35]

Sales taxes are also vulnerable to changes in the economy, and revenues tend to fall during recessions when people purchase less or seek out lower-cost alternatives. During the height of the Great Recession in Michigan in 2009, revenues from the state sales tax fell by 10%.[36]

More importantly, since the sales tax was adopted, consumer spending habits have changed dramatically. Consumer spending has shifted from the purchase of goods, which are taxed in Michigan, to services, which largely are not. Nationwide, between 1959 and 2009, the share of personal expenditures on goods dropped 41% from 54.3% to 32.3%, while expenditures on services increased from 45.7% to 67.7%.[37]

Michigan taxes relatively few services. In 2007, Michigan taxed only 26 services, fewer than 38 states and the District of Columbia.[38] The estimated loss of Michigan sales tax revenue due to the exemption of services was *$10 billion in fiscal year 2010*.[39]

***Use taxes**:* The state's use tax was first established in 1937, also at 3%, and was increased along with the sales tax to 4% in 1960, and 6% in 1994. Use taxes are levied on items that are bought outside of Michigan for use in the state, and have become of greater interest as e-commerce and Internet sales have grown. Two-thirds of the revenues from use taxes are dedicated to the state's General Fund, with the rest used for the School Aid Fund.

Michigan law provides for the taxation of Internet sales, but relies largely on voluntary compliance by consumers. As a result, relatively little revenue is collected. Since 1999, Michigan has included a line on the personal income tax form to make it easier for taxpayers to report use taxes on remote sales. For tax returns processed during 2010, approximately 104,000 taxpayers reported $5.3 million of use tax due, or 1.3% of the estimated use tax liability. 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.[40]

**Michigan Loses Millions in Potential Revenue by Not Collecting Taxes on Remote and Internet Sales**


*Source: Office of Revenue and Tax Analysis, Michigan Department of Treasury*
Produced by Michigan League for Public Policy

***Business Taxes*: Although Michigan has not traditionally been a high tax state with respect to businesses, recent changes have eliminated tax liability for most Michigan businesses and reduced business taxes by 83%.** In 1975, the Michigan Legislature adopted the Single Business Tax (SBT) at a rate of 2.35%—replacing eight previous taxes and fees on a range of business activities. The SBT was replaced in 2007 with the

Michigan Business Tax (MBT), which included an income tax of 4.95%, and a modified gross receipts tax.

In 2011, the Legislature replaced the MBT with a 6% Corporate Income Tax, effective January 1, 2012. The new Corporate Income Tax will generate an estimated $799 million in fiscal year 2013, compared with the $2 billion raised annually by the MBT. However, because some of the specific business credits that were part of the MBT will be honored during the transition, business revenues are expected to plummet in fiscal year 2013 to only $343 million.

The new Corporate Income Tax applies only to Part C corporations with gross receipts exceeding $350,000, so it is anticipated that 95,000, or two-thirds of Michigan businesses, will not be subject to business taxes—even though they clearly benefit from government services such as police and fire services. And, the number of businesses exempt from taxation could grow if corporations change their legal status to avoid taxation.

When fully phased in during fiscal year 2013, Michigan's new Corporate Income Tax will create a revenue loss of roughly $1.6 billion, dramatically reducing the tax burden assumed by businesses. Given current revenue estimates, it is projected that in 2013, the new tax will place Michigan 46th in the nation in Corporate Income Tax revenue per $1,000 of personal income, and 47th in Corporate Income Tax revenue per capita—*last among the states that levy a Corporate Income Tax.*[41]

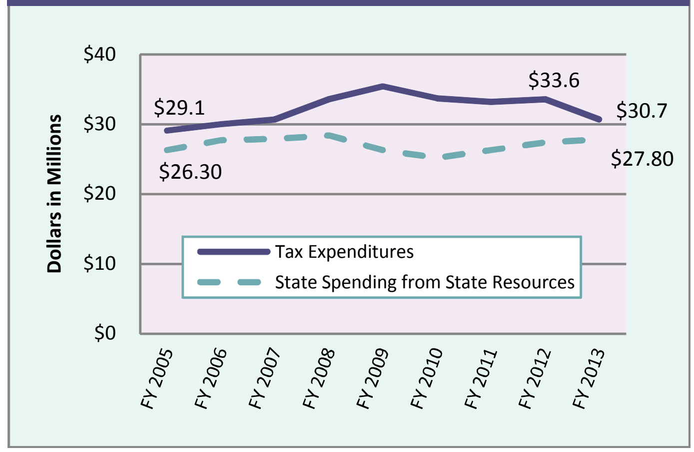
Another major cut in business taxes was approved during the lame-duck legislative session late in 2012 through a phaseout of the state's Personal Property Tax (PPT)—a tax paid by businesses on properties not attached to structures, such as business machinery, equipment and tools. The tax currently brings in about $1.2 billion in revenue and, under the legislation approved, revenues for both state and local governments will be significantly reduced by as yet undetermined amounts.

Particularly at risk are funds for local governments. More than one-third of the revenue from the PPT is used by counties, cities, and townships for police and fire protection and other local services relied on by businesses.[42]

## A CLOSER LOOK AT TAX EXPENDITURES

Tax expenditures are often described as "silent spending," and include tax deductions, deferrals, exclusions and credits given to individuals or businesses. Tax expenditures are considered a form of spending because they allocate funds for specific public purposes, but are not debated and approved during the annual budget process. They have a significant impact on state revenues because they reduce or eliminate revenues that would have otherwise been collected and be available for needed public services.

**Revenues Foregone:**
**Tax Expenditures Exceed State Spending from State Resources**




*Source: Michigan Department of Treasury and Senate Fiscal Agency*
Produced by Michigan League for Public Policy

Over time, tax expenditures have grown to the point that they now exceed state spending from state resources.[43] Between fiscal years 2005 and 2012, tax expenditures increased 15.5%, from $29.1 billion to $33.6 billion. The 2011 tax shift legislation repealed many of the credits allowed in the former Michigan Business Tax, as well as the EITC and other personal income tax credits, so tax expenditures are expected to fall by 8.6% between fiscal years 2012 and 2013.[44]

Currently there is no formal process in place to evaluate the effectiveness of tax expenditures in Michigan. Unlike direct appropriations that are part of the annual budget process, most tax expenditures are put in place and never reviewed. A 1991 state task force reviewing the impact of tax expenditures recommended the following to ensure that tax expenditures are effective and achieving their intended purpose:

- Include a tax expenditure report as part of every Executive Budget.
- Conduct a fiscal impact analysis of all tax expenditure bills, and include a sunset on tax expenditures to ensure that they are evaluated.
- Create a formal process for the review of all tax expenditures, including a joint subcommittee of the taxation and appropriations committees.
- Establish criteria for evaluating tax expenditures.

More than two decades later, only the first recommendation has been adopted, and tax expenditures are now included in annual Executive Budgets. Still missing is a formal process for evaluating whether or not tax expenditures are serving an important public purpose or are simply unnecessary and costly giveaways.

## NEXT STEPS: THE CASE FOR REFORM

### Michigan is falling short in its investments in future economic growth.

The rationale for the major tax shift adopted by the Michigan Legislature last year was that the combination of reducing business taxes and increasing individual income taxes—with a net loss of total revenue of nearly $550 million annually—would improve the state's economy and spur job growth.[45] The evidence doesn't support that policy goal.

**There is a weak connection at best between cuts in taxes for businesses and the wealthy, and increased economic and job growth.**

- Research shows that corporate income tax cuts are unlikely to have a strong positive effect on a state's rate of economic growth or create many new jobs. Corporate tax cuts do not create enough incentives for the corporate investments needed to boost economic output and jobs, and could in fact adversely affect long-term growth by leading to cuts in public services, including those relied on by businesses such as high quality education systems to educate and train workers; good transportation and infrastructure to get employees and supplies to their plants and their products to customers; police and fire protection for their facilities; and the schools, recreation and other community benefits needed to attract highly qualified personnel.[46]
- A study of the effect of state tax policies on economic growth over the past 65 years shows that slashing taxes for the wealthiest taxpayers (the top marginal tax rates) is not a guaranteed way to accelerate economic growth, but rather a fast track to increased income inequality—the gap between high income and other taxpayers.[47]

> Deep cuts to state services also erode the foundations of a strong economy, in both the short and long term. Spending on education, transportation and public safety has been shown to stimulate economic growth in the short run and is among the most important determinants of economic growth and job quality in the long run.[48]
>
> – Erica Williams
> Center on Budget and Policy Priorities

**Research shows that raising taxes on low-income families has both personal and social costs, and will ultimately curb the state's economic growth.**

- Raising taxes on the working poor creates a clear drag on the state's economy in part because lower-income people spend nearly all of the money they make, mainly on necessities, so for every dollar they lose due to a tax increase, total spending drops by around a dollar.[49]
- Recent research suggests that increased taxes on low-income families that reduce available income and increase poverty can impair children's chances of success later in life, making them less productive contributors to their states' future economies.[50] In fact, studies of anti-poverty programs have found that additional family income can boost the test scores of children from low-income families.[51]
- A recent study shows a strong relationship between family earnings in early childhood and earnings later in life for children growing up in low-income families. The study finds that for a child growing up in a family with income below $25,000, a $3,000 annual increase in family income when the child is under 5 years of age is associated with a 19% increase in adult earnings and 135 additional annual work hours after age 25.[52] Further, increasing taxes on the poor can affect high school completion: As taxes on the poor go up, high school graduation rates go down.[53]
- Reductions in family income can be particularly harmful to children. One study found that state EITCs, by relieving prenatal poverty, were related to a reduction in the rate of low-weight births. Reductions in low birth weight have been shown to also reduce infant mortality, improve child health, and increase educational achievement and earnings.[54]

### 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. To achieve the economic prosperity Michiganians want for themselves and their children, Michigan must aggressively pursue tax reforms that modernize its outdated tax system, making it more fair and dependable. The dividends that the state will reap include healthier babies, a more educated and ready workforce, a better quality of life, and long-term economic stability and growth. Priorities for that reform include the following:

### Reduce the income tax burden placed on low-income workers and families.

***Restore the Earned Income Tax Credit (EITC).*** The Legislature should restore the EITC to its original level of 20% of the federal credit. By putting more 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 not only encourages work, but it can increase the likelihood that children will succeed in school and ultimately in the workforce. Research shows that budgetary savings from cutting low-income credits carry with them significant economic costs by making it more difficult to cultivate the highly skilled workforce that states will need to succeed economically.[55]

### Ensure that business tax changes are minimally revenue neutral.

***Increase the rate of the new Corporate Income Tax to replace revenues lost, ensuring that total tax revenues are at a minimum retained at levels projected prior to the tax shift of 2011.*** The great tax shift of 2011 not only made Michigan's tax system more regressive, but jeopardized the state's ability to provide basic public services because it resulted in a net state tax cut of approximately $550 million in fiscal year 2012.[56] Michigan cannot afford a tax shift resulting in the loss of revenue for basic services, including education, that are so vital to the state's economic recovery and growth.

### Modernize the state sales and use taxes.

***Expand the sales tax to selected services***. Michigan's tax system must be modernized to reflect the shift to services. Expanding the sales to tax to additional services is a more equitable way of taxing consumption, and should be a significant component of Michigan's tax system reform.

***Establish mechanisms to enforce the taxation of Internet sales***. Taxing Internet sales would level the playing field for Michigan businesses. Currently, Michigan's brick and mortar businesses collect the sales tax on purchases. However, when consumers purchase items online from out-of-state retailers, Michigan businesses are disadvantaged. As Internet sales have grown, many states, including Michigan, have signed agreements to streamline their tax structures to facilitate the collection of taxes on e-commerce. Legislation was introduced in Michigan (House Bills 5004 and 5005), known as the Michigan Main Street Fairness Act, that would mandate that remote sellers collect taxes on Internet sales. The taxation of Internet sales is needed if Michigan is to ensure that its current tax system reflects the realities of the economy and consumer choices.

### Scrutinize all forms of spending, not just annual appropriations, to ensure they contribute to economic and human capital development.

***Review tax expenditures (breaks) annually to ensure that they are achieving their goals***. While Michigan does provide information about tax expenditures as part of the annual Executive Budget, there is still no consistent process to review tax expenditures, and Michigan continues to forgo billions of potential revenues without any regular oversight. Part of a balanced approach to addressing Michigan's fiscal problems must be the evaluation of tax expenditures, with greater overlap between appropriations and taxation committees in the Legislature. Tax expenditures that are out of date with consumer habits, have little impact on job creation, or don't serve a useful public purpose should be ended not only as a way to help balance budgets but also because it is sound tax policy.

***Invest in state priorities that are fundamental to job growth and economic development, including education, health, high quality early education, and basic income supports***. The evidence is clear. For Michigan to enjoy true economic prosperity and growth, there must be adequate investments in the services that are known to develop the next generation of workers, and that ensure a high quality of life. The disinvestments of the last decade have been devastating, and cannot be continued. Adequate and stable revenues are the foundation for a solid Michigan budget, but we must also be very strategic in how we spend those resources to build human capital.

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