Citizens Research Council of Michigan

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Summary Digest of Michigan Tax Study Staff Reports

As a public service the Research Council has prepared this digest of a staff report to the Michigan State Tax Study Committee. The Committee is considering basic changes in the state's tax structure and these digests have been prepared to inform the public as to what is being considered by the Committee. It should be emphasized that the material presented is a digest of the staff report to the Committee and does not represent the findings or opinions of the Michigan Tax Study Committee, its citizens advisory committee, or the Research Council.

Memorandum #192, No. 1 March 7, 1958

THE PERSONAL INCOME TAX

INTRODUCTION

For the vast majority of states, the two major sources of revenue are taxes on the net income of individuals and corporations and general sales or gross receipts taxes. Since both taxes have broad bases, they are productive of revenue even though rates are low; and since the rates are low, there is relatively little risk in losing population and business to competing states. A total of 29 states and the District of Columbia levy personal income taxes at the present time. By comparison the number of states employing sales or gross receipts taxes is 33. In 1957 personal income taxes were the third most productive state revenue source, producing $1,563 million. In the same year, the general sales tax yield for all states was $3,821 million.

The income tax is a more important source of revenue at the state level today than in 1941. In particular states, the individual income tax produces over 30% of state revenue, while it is responsible for over 20% of state revenue in several other states. Several large and industrialized states such as Illinois, Indiana, Ohio, Michigan, and New Jersey, have neither a corporate nor an individual income tax.

The number of states using both sales and personal income taxes exceeds the number using only a sales tax or only an income tax. Eighteen states have both sales and personal income taxes; fifteen states have only a sales tax; twelve states have only a personal income tax; and three states have neither sales nor personal income taxes. In the eight-state group given particular attention in the Michigan Tax Study; New York and Wisconsin have only a personal income tax; and New Jersey has neither a sales nor a personal income tax.

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A PERSONAL INCOME TAX IN MICHIGAN

Constitutionality

The constitutionality of an individual income tax in Michigan is clouded in uncertainty. The general assumption has been that a constitutional amendment would be necessary, but no one actually knows. An opinion of the Supreme Court could provide a definitive answer, but the question has never been reviewed by that court.

The questions involved are whether the constitution prohibits an income tax and, if not, whether it restricts the rate of taxation. These sections of the Constitution are involved.

1. Article X, Section 3 requires a uniform rule of taxation, except on property paying specific taxes;

2. Article X, Section 4 authorizes the legislature to impose specific taxes, which shall be uniform upon the classes on which they operate, and

3. Article X, Section 21 provides for a limit of 15 mills on taxes assessed against property, but includes a provision for raising the limit.

The principal constitutional issue is whether a personal income tax is an ad valorem or a specific tax. If a personal income tax is an ad valorem tax then it would be subject to the uniform rule of taxation and a progressive rate would be unconstitutional. A flat-rate tax might be constitutional, but this is uncertain. However, there is reason to believe that a personal income tax could be construed as a specific tax and, if so, there would be no constitutional restrictions on a progressive tax.

Another issue is whether the 15 mill limitation is applicable to a tax on income on the grounds that income is property. It appears unlikely that the Supreme Court would invalidate a personal income tax on this basis.

Michigan has two alternatives in order to resolve the constitutional questions: a statute could be enacted and tested in the Supreme Court; or, a constitutional amendment could be submitted for voter approval. Proposed amendments to the Michigan constitution, which would have authorized an income tax with restrictive features applicable to rates, exemptions, or use of the proceeds, were defeated on four occasions, in 1922, 1924, 1934, and 1936. It cannot be determined whether the voters disapproved of the tax in principle or disapproved of the particular circumscribed form of the tax. Innumerable personal income tax bills have been rejected by the legislature.

Estimated Yield

Revenue estimating is far from an exact science. It is particularly difficult to estimate the yield of a personal income tax in Michigan because information such as brackets, rates, exemptions, income distribution, and level of enforcement is not

known. However, rough estimates of yield can be made. For example, the relatively high progressive rates, low exemptions, and limited federal tax deductibility of the Wisconsin tax would yield about $224 million a year in Michigan, while the New York tax, with lower rates and higher exemptions, would yield about $186 million, and the mildly progressive Iowa tax would produce only $90 million. The Maryland and Massachusetts flat-rate taxes would provide collections in the area of $165 million. A flat-rate tax imposed at a rate of 1.5 per cent on income as defined for federal tax purposes, including the application of the federal dependent's allowance of $600, would be likely to produce $100 million a year in Michigan and would be progressive in its effect. If a possible Michigan individual income tax is to be designed to yield a given amount, it would be possible to devise any types of effective rate progression so that approximately this yield would result.

THE ADVANTAGES AND DISADVANTAGES OF STATE PERSONAL INCOME TAXES

The most meaningful way to evaluate the personal income tax at the state level is to compare it with an alternative tax. The best alternative tax for this comparison is the broad category of taxes composed of retail sales or gross receipts taxes.

Equity

Equity becomes dominant in the issue of sales versus income taxation for two reasons: 1) for other important considerations, such as revenue productivity and the effect of taxation on the level of business activity, there is not a striking difference between the two taxes; and 2) the remaining criteria, such as stability of yield and administration, are of secondary importance to equity.

Proponents of a personal income tax maintain that it is more equitable than a sales tax because income in the principal source of tax payments, and therefore is the best measure of ability to pay. The progressive rate feature of the income tax is an attempt to equalize the tax burden among individuals. Progressive rates are based on the idea that the last dollar received by a person with high income has less utility (individually and socially) than the last dollar received by a person with low income, and for this reason, the higher income should be taxed at a higher rate. Further, the personal income tax takes into account differences in family responsibilities by allowing deductions for dependents and for certain extraordinary personal expenses.

The sales tax, on the other hand, is regressive in its effect. That is, the percentage of tax to income for a low income taxpayer is higher than it is for an upper income taxpayer, because a greater proportion of low income is spent on taxable expenditures. Even a flat-rate personal income tax is related more closely to tax paying ability than a sales tax because it takes into consideration the number of dependents of the taxpayer and certain deductions related to his individual ability to pay.

To some degree, the income tax at the state level is a "class tax". The progressive rates of the income tax, in addition to the federal personal income tax rates on much the same basis, have given rise to the argument that it is objectionable to levy an additional income tax on a base already heavily exploited by the federal government.

The following points discuss the issue of whether or not state personal income taxes have justification from the point of view of equity at the state level:

1. Most taxes in the last analysis must come out of the actual or potential income of individuals. Proponents argue that it is preferable to tax income directly rather than to tax a given partial use of income, such as the purchase of tangible personal property.

2. The real issue is whether state and local tax systems should be regressive in order to offset in part the progressivity of the federal tax system, or whether the progressivity of the federal tax system should be accentuated by a less regressive state and local tax system. A definitive study has found that the present tax system for all levels of government places a relatively heavy burden on low income groups. There is no question that the distribution of state and local payments (for the aggregate of all states) is regressive throughout the income scale, and that the federal income tax is the dominantly progressive element. Of the eight states chosen for comparison in the Michigan Tax Study, Michigan ranks third highest in the ratio of direct and indirect taxes levied on individuals.

3. The personal income tax can be defended as a means of exacting additional payments from individual proprietorships and partnerships who presently receive more favorable treatment than the corporate form of business which is subject both to the state corporate franchise tax and the federal corporate income tax. Likewise, a personal income tax, if accompanied by repeal of the intangibles tax, would remove some of the difference in tax treatment of income from different groups.

4. Finally, mention should be made of mitigating influences on the progressivity of an income tax: a) bracket progression produces an effective progression much lower than the sequence of bracket rates; b) there are a host of opportunities to minimize the federal personal income tax liability, such as tax-exempt bonds, the low rate on capital gains, etc.; and c) the deductibility of state income taxes from income for federal tax purposes and the reciprocal deductibility of federal income taxes in about two-thirds of the states results in only a mild increase in the marginal rate.

Other Considerations

Productivity: Personal income and general sales taxes are so broadly based that they are capable of producing the quantity of receipts required of a state government without at the same time prejudicing the competitive tax position of a particular state.

Incidence: In general, a net income tax has an advantage over taxes on sales on the issue of shifting and incidence. The burden of a net income tax is more certain and measurable.

Redistribution of Income: The progressive income tax is an instrument for the reduction of the inequities of wealth and income.

Allocation of Resources: A characteristic feature of general sales taxes is the provision of exemptions for certain goods and services, which tends to impede the optimum allocation of income, and hence resources, by diverting purchases from taxed to untaxed goods and services.

Effect on Price Levels: Income taxation is considered to be less deflationary than equal revenues collected in the form of sales taxes. However, the argument that one tax should be favored over the other at the state level on the grounds of its price stabilization effects is essentially weak because of the relatively minor effect of state taxation on the level of prices.

Stability of Yield: A characteristic of progressive income taxes is that their yields fluctuate more violently than economic conditions. The relative instability of an income tax is a hardship for state governments during the downswing of a business cycle. On the other hand, while the stability of a sales tax is an advantage to the state government in a recession, it is a disadvantage to both the economy and to individuals. During an inflationary period, the responsiveness of the income tax to economic expansion works to the advantage of state government finances by providing rising collections to meet expanding budgets.

Tax Consciousness: It is argued that tax consciousness is promoted by an income tax because the tax is direct and not hidden and is paid in a relatively large lump-sum amount. However, the income tax exempts a sizeable group from taxation which defeats tax consciousness among that group.

Administration: From an administrative point of view, the advantages would appear to lie in favor of a sales tax over an income tax. The complex and intricate refinements of an income tax constitute both a compliance and enforcement burden.

Convenience: The payment of a sales tax in pennies or small amounts is relatively painless for most taxpayers as compared to making a large lump sum payment under an income tax. Withholding under an income tax has made compliance easier, but there is still the need for making a tax payment on income not subject to withholding.

Impact on Economic Growth: There is no firm or incontrovertible evidence which suggests that either a personal income tax or a general sales tax at the state level has deleterious effects on economic growth. Both taxes are also relatively free of criticism on the issue of tax differentials as a locational factor for industry. Direct business taxes levied at the state level and real and personal property taxes levied at the local level generally bear the brunt of this criticism.

PRACTICE AND EXPERIENCE IN OTHER STATES

Comparative Personal Income Tax Burdens

A comparison of effective personal income tax burdens among individuals in different states is difficult because each taxpayer is actually a unique case. An approach to measuring relative personal income tax burdens is to express income tax collections on a per capita basis and as a percentage of personal income. On a per capita income tax basis the 29 state average is $15.15. Expressing the tax payments as a percentage of $100 of personal income the 29 state average is .86 per cent. Finally, attention may be given to the proportion of state revenues raised by individual income taxes. In 1957 personal income taxes yielded $1,563 million, making it the third most important revenue producer at the state level. Income taxes produced 10.83 per cent of total tax collections in all 48 states, and accounted for 17.86 per cent of tax collections in the 31 states levying the personal income tax. Only 10 states obtain more than 20 per cent of state-collected taxes from the income tax, while 12 states receive less than 10 per cent and four receive less than 5 per cent.

Characteristics of State Personal Income Tax Levies

The Base In general, the tax base for the personal income tax at the state level includes the same type of income taxable under federal law, but there is some variation in the treatment of a few items of income and in the allowance of certain deductions. In some instances it is possible to improve upon federal requirements. But, subjecting the taxpayers to two sets of income tax requirements makes compliance and enforcement more difficult. The most prudent approach is to establish a presumption in favor of following federal requirements unless compelling reasons dictate otherwise. There has been a trend toward uniformity within recent years. Alaska, New Mexico, and Utah have adopted the same tax base as the federal government.

Exemptions and Credits Exemptions are allowed in two different ways under state laws: 27 states provide for personal exemptions by net income deductions and four states by credits against the tax. An exemption in terms of tax results in a more progressive tax structure than when the exemption is in net income. In the states, exemptions for married persons average about $2,000 and the average dependency allowance is about $450. Exemptions are more often dictated by administrative considerations, expediency and the need for revenue than by considerations of equity or social desirability.

Income Bracket The effective rate structure of a personal income tax is determined to a considerable degree by dividing taxable income into brackets and by applying a schedule of rates to particular brackets of income. These brackets are important in determining the progressivity of the tax. Income brackets vary considerably among the states – the lowest first bracket being $500. There is also considerable variation in the top brackets of income, with 14 states having top brackets starting below $10,000. There

are only a few states in which progressive rates are applied to relatively high income – only five states have top brackets beginning at $25,000 and above.

Rates State income tax rates are much lower than federal rates, but there is little uniformity in rate structure among the states. An arithmetical average for the starting rate in all states is 1.5 per cent. Most of the states have top brackets between 4 and 6 per cent, with the arithmetical average for all states being 5.9 per cent. Only 2 states have flat-rate personal income taxes. The principal explanation for this variation in rates is that rate graduation often is based on expediency and suffers from the fact there is no precise objective measure of equity or taxpaying ability.

The Progressivity of State Personal Income Taxes Rates and exemptions are probably the two most important issues in the drafting of a personal income tax statute. Progressivity of rates alone does not make a striking difference in the tax burden at low levels of income, but there is a contrast at higher incomes. Personal exemptions deducted from income affect progressivity because the exemption is subtracted from income subjected to higher rates of tax and thus the dollar amount of the tax savings from the exemption increases as the income rises. However, exemptions increase the over-all progressivity of the rate structure because the exemption reduces the tax liability of low income groups proportionately more than upper income groups. This is significant because low income taxpayers benefit disproportionately and there are a greater number of these.

Another issue of importance affecting progressivity of a state income tax is the deductibility of income taxes. The federal government permits the deduction of state income taxes from taxable income, and 20 state personal income taxes permit full or partial deduction of federal income taxes paid. Deductibility has three important consequences:

1. A state progressive income tax adds relatively little to the progressivity of the combined federal-state tax structure when mutual deductibility is allowed.

2. A state income tax adds relatively little to a taxpayer's cost as compared to what it adds to state receipts. In effect, money is transferred from the federal to the state government.

3. The difference in the income tax burden among high income tax states and those with either low rates or no individual income tax are not as great as they appear because deductibility reduces high statutory marginal rates to relatively low effective rates.

Administration

While not an easy tax to administer, it is recognized that the income tax can be effectively and efficiently administered given a conscientious effort. Over-all about 10 per cent of total federal personal taxable income is lost by evasion. The figure is

probably higher at the state level because the quality of state administration is generally inferior to the federal. Admittedly, the personal income tax is more difficult to administer at the state level than at the federal. The withholding device has been a particular boon to state income tax administration with ten states now using a system similar to the federal system. The taxation of income by both the federal and state governments is an administrative advantage.

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