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PERSPECTIVES ON MICHIGAN'S STATE PERSONAL INCOME TAX

Summary

State policymakers have long harbored a peculiar love-hate relationship with the personal income tax. Part of that relationship is based on economics. It is the largest source of state tax revenue. Besides the property tax, it is the only tax widely available to Michigan cities. The personal income tax has been relied upon to generate new revenues during lean economic periods, and it is the tax state policymakers most often turn to as a way to offer tax relief.

The question of whether to levy a tax on personal income is as much about political ideology as it is about economics. People will differ on the value they place on the size of government, and reducing or eliminating a major source of revenue for the state may result in reductions in the size of government. People will differ on the value they place on taxes on income relative to consumption taxes, sin taxes, or property taxes.

History

As with any policy issue, understanding the past can be instrumental to determining a course for the future. On the matter of income taxation, it is equally useful to consider both the state government's history in levying this tax and the history of the local-option city income tax in Michigan.

State Income Tax Rate Changes

In Michigan's 50 year history with the income tax, the tax rate has rarely remained at the same rate for more than a few years. The tax has been levied at a rate greater than four percent for most of the last 35 years.

State policymakers have mounted repeated efforts to reduce the tax rate to 3.9 percent. An effort initiated in 1999 reduced the tax rate by 0.1 percentage point over five years. This period overlapped with the onset of Michigan's single state recession. In the face of cyclical economic tides that were resulting in tax revenue reductions, the statutory tax rate reductions helped to create the state's structural budget deficit and worsened Michigan's single state recession.¹

Eventually, difficult economic conditions led to statutory changes that increased the tax rate from 3.9 percent to 4.35 percent in 2007.² The statutory changes that triggered that

increase also called for future tax rate reductions to occur automatically. Beginning in 2011, and each year thereafter, the tax rate was to reduce by 0.1 percentage point until the rate reached 3.9 percent in 2015.³

However, in the face of continued economic struggles, the Income Tax Act was amended before those automatic rate reductions could begin and the rate was set at its current 4.25 percent.

Future Changes

The state personal income tax rate stands to be reduced in the future because of a provision that was adopted as part of the road funding package enacted at the end of 2015. Beginning in tax year 2023, the personal income tax rate would be reduced in any fiscal year for which cumulative general fund/general purpose (GF/GP) revenue growth exceed 1.425 times the cumulative rate of inflation over the same period. The revenue effects from the rate reduction are specifically targeted to affect the GF/GP budget. The provisions do not return the tax rate to previously authorized levels if revenues in future years fall below the calculated amount tied to inflation.

Adequacy of Tax Revenues

It can be asked whether state tax revenues in general or revenues specifically from the state personal income tax are "adequate". Adequate may connote different things to different people. Thus, this analysis uses three methods of evaluating adequacy from different perspectives:

1. Current revenues measured against historic tax revenues.
2. Current revenues measured against the constitutional tax limitation created by the Headlee Amendment.
3. Michigan tax revenues compared to other states.

Measuring against Previous Year Tax Revenues

Fiscal Year (FY)2016 nominal tax revenues of \$27.3 billion were slightly more than the previous high point of \$26.6 billion in FY2008. When total tax revenues are adjusted for inflation to take into account the change in price of government services over time, it becomes evident that FY2015 revenues were 13.2 percent less than the FY2000 peak of \$31.6 billion. When adjusting for inflation, FY2015

1 Michigan's Fiscal Future, Citizens Research Council of Michigan Report #349, May 2008, <http://crcmich.org/PUBLICAT/2000s/2008/rpt349.pdf>.

2 Because the rate increase to 4.35 percent occurred late in 2007, the effective annual rate was 4.01 percent.

3 Public Act 94 of 2007.

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tax revenues were at levels last seen in FY1995 (except on the way down in FY2009).

Michigan personal income tax revenues were on a fairly constant growth path from the time of their adoption until the start of Michigan's single state recession in 2001. After experiencing some fairly large swings in the decade that followed, Michigan income tax revenues have been on a growth path in the past five years. FY2016 income tax revenue of \$9.2 billion were higher than the FY2008 peak of \$7.3 billion or the FY2000 peak of \$7.2 billion (See **Chart A**). However, the \$9.2 billion collected in FY2016 is still 10 percent less than the inflation-adjusted FY2001 peak of \$10.0 billion. When adjusting for inflation, FY2015 income tax revenues were at levels last seen in FY1997 (except on the way down in FY2001).

Measuring against the Constitutional Revenue Limit

The Headlee Amendment added Section 26 to Article IX of the 1963 Michigan Constitution to create a state revenue limit as a ratio of state revenue collected to personal income measured in that fiscal year. The Headlee revenue limit is fixed at 9.49 percent for each year.

The advent of Michigan's single state recession beginning in 2001 caused the state to fall far below its revenue limit. Current total tax revenues flowing into the general fund/general purpose budget of \$8.5 billion are less than half of the revenues the state is permitted under the revenue limit.

Measuring Michigan against Other States

In 2013, Michigan ranked 35th highest in the U.S. at \$3,750 of total state and local government tax revenue per capita. Michigan was 34th highest in the nation with \$96 of total tax

revenues per \$1,000 of personal income. Michigan's ranking against other states decreased by 21 places, mirroring the national shift toward lower taxation in the past two decades.

Michigan's personal income tax revenue burden ranked 34th in the nation on both a per capita basis and as a percentage of personal income. Collections for 2013 equaled \$866 per capita, 81 percent of the national average, and \$22 per \$1,000 of personal income, 92 percent of the national average.

Personal income taxes are levied in 43 states. Of these, 41 tax wage and salary income, while two states – New Hampshire and Tennessee – only tax dividend and investment income. The other seven states levy no income tax at all. Michigan is one of eight states that levy a flat rate tax on individuals.

When using the tax rates applied to the highest income brackets as a basis for ranking states, Michigan's 4.25 percent tax rate is relatively low. Only five states – North Dakota, Pennsylvania, Indiana, Illinois, and Wisconsin – levy lower tax rates on individuals in the highest income brackets.

Reliance on Personal Income Tax Revenues in Other States

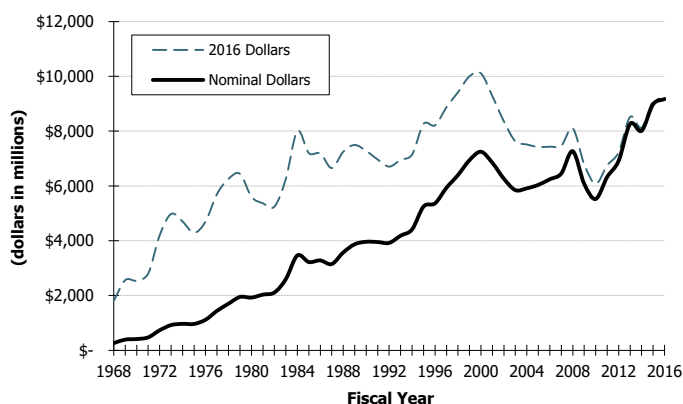
State and local government tax systems are often measured against an ideal in which three tax components – property, sales, and income taxes – contribute roughly equally to the total. Economists argue that this "three-legged stool" model of taxation provides the optimal state tax system, minimizing deadweight loss from inefficient taxation and reducing distortionary effects on the economy. In 2013, Michigan collected 95 percent of its tax revenues from the three major tax components outlined above in one form or another.

Seven states – Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming – do not levy a personal income tax at all and two states – New Hampshire and Tennessee – only tax dividend and investment income. On the other hand, five states – Alaska, Delaware, New Hampshire, Montana, and Oregon – do not levy a state sales tax.

The ability of states to stray from the norm rests on the economic drivers of their states and the tax policy priorities each state has in place. Florida and Nevada benefit heavily from the tourism industries that drive their state economies and each receives more than half of the state tax revenues from sales tax revenues. South Dakota, Texas, and Washington benefit less from tourism, but each receive more than half of their state tax revenues from the sales tax. Alaska, Texas, and Wyoming benefit greatly from the oil and mineral extraction that are significant parts of their state economies. The Alaska Permanent Fund pays people to live in Alaska, rather than taxing them based on their economic activity.

Chart A

Personal Income Tax Revenues, FY1968-FY2016



Source: Michigan Department of Treasury, CRC calculations to adjust for inflation using U.S. CPI-U as determined by the U.S. Department of Commerce.

Role of Michigan's Personal Income Tax

If the personal income tax goes away:

1. Can revenues from existing taxes grow at sufficient rates to make up for the loss?
2. Where will replacement revenue come from?
3. What will be the state budget reductions to ensure budget balance?

As is evident in **Chart B**, the personal income tax and the sales and use taxes are the primary sources of tax revenues for the state government. These three taxes contribute nearly 75 percent of the state's tax revenues. Other tax revenues flow from sin taxes, such as tobacco and liquor, business taxes, such as the Corporate Income Tax and the insurance company tax, and the State Education Tax.

The GF/GP budget funds all functions and services for which there are no dedicated sources. It receives more than 72 percent of the revenue from the personal income tax. Other revenues are derived from the undedicated portion of the sales, use, and tobacco taxes, and from business taxes.

Options if the Income Tax is Reduced or Eliminated

The prospects for reducing or eliminating the state personal income tax must be considered in light of the Michigan Constitution's mandate for a balanced budget. If the state

personal income tax rate is reduced or the tax is eliminated, policymakers can consider several options to address the revenue decline from this source:

1. They can rely on existing tax sources to grow at sufficient rates to make up for revenues lost from the income tax,
2. They can adjust the tax rates levied on other taxes to generate revenues that would replace lost income tax revenues, or
3. They can cut spending as revenues decline to keep spending in line with available resources.

Each option includes complications. Provisions in the Michigan Constitution or state law affect the use of tax revenues and tax rates that may be applied. Appropriations reductions in some areas will result in more than a dollar-for-dollar decline in spending because of federal matching requirements that may not be matched. And because of the nature of how state tax dollars are used, reductions in state resources will stand to affect school districts, community colleges and universities, local governments, hospitals and other health providers, and many other public and private entities that receive state funding to carry out public purposes.

None of the taxes flowing into the GF/GP budget have been very robust since 1994. The individual income, sales, and use taxes experienced some growth in the late 1990s. That growth was washed away during the first decade of this century, more so for the personal income tax than for the sales and use taxes. Tobacco tax revenues experienced several peaks during the period in question driven by changes to the tax rates applied to tobacco products. Based on past experience, there is little prospect of revenue from existing taxes growing at sufficient rates to make up for lost income tax revenue.

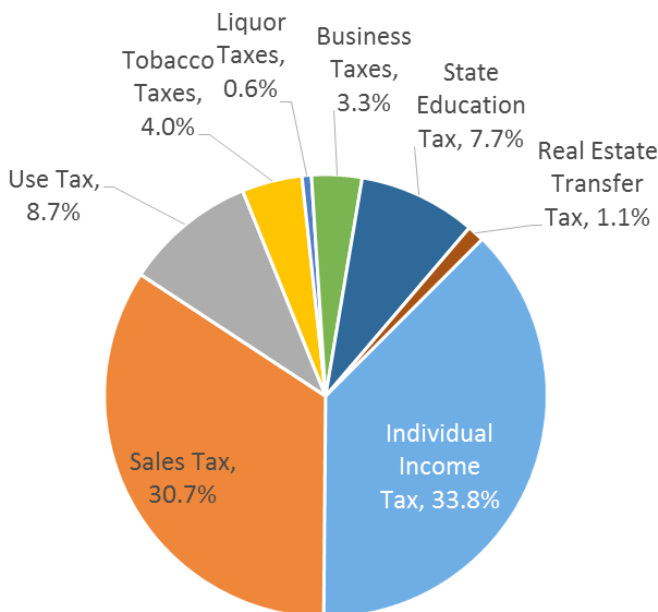
The idea that the growth of existing tax revenues could be sufficient to make up for reduced income tax revenue is further complicated by Michigan's heavy reliance on earmarking. Earmarking, or dedicating, refers to the practice of reserving revenues from specific sources for specific functions. Michigan is among a few states that rely heavily on the practice of earmarking state tax revenue to specific purposes. In FY2014, nearly 63 percent of the total was earmarked (\$15.3 billion).

The personal income tax has proven to be a robust source of revenue for the state. Replacing revenues from that tax with new taxes or increases in tax rates on existing taxes would not be easy. Generally, sales and property taxes are the only other taxes capable of raising large sums of revenue (in the magnitude of the current state personal income tax).

Efforts to increase the sales tax rate are complicated by

Chart B

Major Sources of Michigan State Tax Revenue, FY2015



Source: 2014-15 Annual Report of the Michigan State Treasurer, www.michigan.gov/documents/treasury/State_Treasurers_Annual_Report_2014-15_524479_7.pdf.

PERSPECTIVES ON MICHIGAN'S STATE PERSONAL INCOME TAX

constitutional limitations on the tax rate and constitutional and statutory earmarking of the tax revenues. A reliance on the sales tax to fund a larger share of state spending is also hindered by the state's failure to include many services in the sales tax base. Michigan's major consumption taxes on the sale and use of tangible property and a limited number of services do not connect effectively with our ever-increasing service-oriented economy.

The property tax is the other tax capable of yielding sufficient revenues to make up for what would be lost with reduction or elimination of the personal income tax. But even with a statewide tax base of \$327.4 trillion, it would require a tax rate of nearly 30 mills to generate the revenue produced by the 4.25 percent tax rate on personal income.

Like the sales tax, the property tax is less attractive as a potential source of replacement revenue because of constitutional provisions. Specifically, the taxable value system of valuing property for purposes of taxation, combined with a long stretch of relatively low inflation, has resulted in a very low rate of growth in the statewide taxable value and therefore, slow growth in the property tax revenues.

State spending differs from that of other governmental units (e.g. school districts, municipal governments) in that less than 20 percent of annual expenditures finance programs that the state directly operates itself and only approximately 11 percent of the total budget each year supports the compensation of state employees (this is a much lower percentage than in any other governmental sector in Michigan). The rest of the state budget (about 80 percent) supports programs operated by non-state government organizations. Given these realities of the state budget, substantial cuts to state spending effectively means reducing the budgets of other organizations.

The GF/GP budget funds community health and Medicaid services, corrections, community colleges and universities, human services, state police, and such governmental functions as the governor's office, the legislature, the attorney general's office, treasury, management and budget, and

other parts of the administration of state government.

Some of the state resource committed to the GF/GP budget are used to draw down funding from federal programs. These programs require the state and/or local governments to contribute to the funding of the program. As a result, a reduction in resources committed to the GF/GP budget can have the effect of reducing spending by a greater amount.

When considering a reduction in resources committed to the GF/GP budget, it is necessary to recognize the existing commitment of state resources that either earmark available resources to specific spending programs or have the effect of reducing the amount of available resources. These include the future redemption of business tax credits that will diminish tax revenues, the commitment of GF/GP resources for highway funding, tax credits for low and moderate income households that will diminish tax revenues, personal property tax reimbursement to local governments that commits resources away from the GF/GP budget, changes in funding obligations for the Healthy Michigan plan that will draw upon GF/GP resources, changes to the use tax related to taxation of the Medicaid managed care organization that will diminish GF/GP resources, changes to the sales tax related to the sale of automobiles and watercraft, other sales tax changes that will diminish state resources, and the pending cost of funding indigent defense in criminal cases.

Conclusion

Michigan's love-hate relationship with the personal income tax appears to be entering a new chapter. Legislative attention on the tax imagines ways to reduce the tax rate or eliminate the tax altogether. Such an exercise will not come easily and would have implications for the efficacy of government services: not just the state government but also counties, cities, villages, townships, school districts, community colleges, universities, and many public and private providers of government services that rely on state appropriations. Changes stand to affect the ability of those governments to provide public goods and services, thus affecting the quality of life for residents and businesses in Michigan.

PERSPECTIVES ON MICHIGAN'S STATE PERSONAL INCOME TAX

Introduction

Michigan laws authorize the levy of 61 state and local taxes: 39 may be imposed by the state and 22 taxes may be imposed by local governments. Among the 39 state taxes, the state personal income tax yields the most revenues contributing nearly 34 percent of total state revenues. This tax also attracts a large amount of attention from state policymakers. Consistent with that attention, some legislators have recently proposed efforts to scale back the tax rate or completely eliminate the state personal income tax.

State policymakers have long harbored a peculiar love-hate relationship with the personal income tax. Part of that relationship is based on economics. It is the largest source of state tax revenue. Besides the property tax, it is the only tax widely available to Michigan cities. The personal income tax has been relied upon to generate new revenues during lean economic periods and it is the tax state policymakers most often turn to

as a way to offer tax relief. Tinkering with the income tax has not always been popular, with the recall of two state senators tied to at least one of the tax increases to address the state's fiscal imbalance.

The question of whether to levy a tax on personal income is as much about political ideology as it is about economics. People will differ on the value they place on the size of government, and reducing or eliminating a major source of revenue for the state may result in reductions in the size of government. People will differ on the value they place on taxes on income relative to consumption taxes, sin taxes, or property taxes. It is not the goal of this report to weigh in on these ideological issues. Rather, this report explores the economics of the state's personal income tax to help state policymakers and citizens understand the role it plays and the consequences of tax rate reductions or complete elimination of the tax.

Perspectives on Michigan Income Tax Rates

As with any policy issue, understanding the past can be instrumental to determining a course for the future. On the matter of income taxation, it is equally useful to consider both the state government's history in levying this tax and the history of the local-option city income tax in Michigan.

Michigan was relatively late in adopting a personal income tax. Michigan adopted the personal income tax in 1967. Other states had adopted income taxes as far back as the nineteenth century.

The personal income tax is calculated as the statutorily determined tax rate applied against a tax base. Michigan, pursuant to Section 7, Article IX of the 1963 Michigan Constitution, levies a flat rate tax. Ten other states levy flat rate taxes. The other states that levy a personal income tax have graduated, or progressive, systems for which the tax is applied at higher rates as levels of income increase.

Michigan, like most other states with a personal income tax, defines the tax base as federal adjusted gross income of individuals, estates and trusts, with certain adjustments. The Michigan law adds back in such things as interest income from state/local obligations and certain other exclusions from federal adjusted gross income. From the federally defined adjusted gross income, Michigan income taxpayers may subtract personal and dependency exemptions, interest income from federal government obligations, armed forces compensation, railroad pensions, National Guard pension or retirement benefits, Social Security income, retirement benefits for some retirees, advance tuition payments made under the Michigan Education Trust Act, interest, dividends, or capital gains, claims for recovered assets received by Holocaust victims, educational savings account or "Achieving a Better Life Experience" (ABLE) savings account contributions, and gains from initial equity investments.

Michigan income taxpayers may also claim tax credits for homestead property taxes, property taxes paid on rented homesteads, farmland property taxes, earned income for low income taxpayers, income tax paid to another state, and home heating costs for low-income families.

As with most tax systems, both the tax rate and the tax base have been adjusted over the years.

State Income Tax Rate Changes

In Michigan's 50 year history with the income tax, the tax rate has rarely remained at the same rate for more than a few years. It was initially introduced at a rate of 2.6 percent. Within a few years it was ratcheted up to 3.9 percent and then 4.6 percent. Efforts to address revenue shortfalls in the early 1980s by increasing the tax rate as high as 6.35 percent proved very controversial. Ultimately, the rate increase led to the recall of two state senators and set a tone for taxation to this date. The rate was soon returned to 4.6 percent and then reduced to 4.4 percent entering the 1990s.

In 1999, the Income Tax Act was amended to automatically scale back the tax rate in increments over a five year span. The amendment triggered a 0.1 percentage point per year reduction from 1999 to 2004, taking the tax rate from 4.4 percent to 3.9 percent.¹

This experience provides lessons for any current and future efforts to scale back tax rates by instituting automatic tax rate reductions spread over several years. While the nation experienced a recession triggered by the events occurring on September 11, 2001, and Michigan was beginning what was to become a decade of economic decline, state policymakers held fast to letting the automatic tax rate reductions occur. In the face of cyclical economic tides that were resulting in tax revenue reductions, the statutory tax rate reductions helped to create the state's structural budget deficit and worsened Michigan's single state recession.²

Eventually, difficult economic conditions led to statutory changes that increased the tax rate from 3.9 percent to 4.35 percent in 2007.³ The statutory changes that triggered that increase also called for future tax rate reductions to occur automatically. Beginning on October

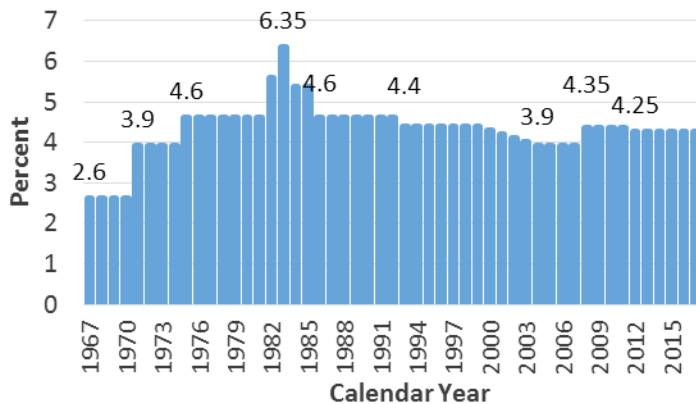
1 Public Acts 2-6 of 1999.

2 *Michigan's Fiscal Future*, Citizens Research Council of Michigan Report #349, May 2008, <http://crcmich.org/PUBLICAT/2000s/2008/rpt349.pdf>.

3 Because the rate increase to 4.35 percent occurred late in 2007, the effective annual rate was 4.01 percent.

Chart 1

Michigan Personal Income Tax Rate History, 1967-2016



Source: Effective Tax Rate from *Michigan's Personal Income Tax 2013*, Office of Revenue and Tax Analysis, Michigan Department of Treasury, May 2016.

1, 2011, and each October 1 thereafter, the tax rate was to reduce by 0.1 percentage point until the rate reached 3.95 percent in 2014. The rate would have been further reduced to 3.9 percent on October 1, 2015.⁴

However, in the face of continued economic struggles, the Income Tax Act was amended before those automatic rate reductions could begin and the rate was set at its current 4.25 percent.

City Income Taxes

Some Michigan cities took action to adopt income taxes before adoption of the state income tax. Detroit and Hamtramck were the first to adopt city income taxes in 1962 and Flint, Saginaw, and Highland Park soon joined them.

The adoption of income taxes in these cities preceded enactment of the state law authorizing city income taxes. Under the 1908 Michigan Constitution, cities enjoyed the latitude to enact taxes as needed to meet their needs. While the 1963 Michigan Constitution seemed to extend that ability, an implementing law, Public Act 243 of 1964, provided that "a city or village shall not impose, levy or collect a tax, other than an ad valorem property tax, on any subject of taxation" unless provided by law. To create uniformity and to provide that authority, the Uniform City Income Tax was adopted in 1964.⁵

State law provides the option of an income tax to all Michigan cities. Villages, townships, counties, school districts, and special authorities are not authorized to levy a local-option income tax under the act. In 1994, the City of Ionia became the most recent of the 22 Michigan cities to enact an income tax.⁶

Cities have done little tinkering with their income tax rates. The act provides that non-residents working in the cities are to be taxed at half the rate levied on residents of the cities. For most of the income tax cities this translates to a 0.5 percent tax on non-residents and 1.0 percent tax on residents. To meet revenue needs, the law was amended several times over the years to make special provision for higher tax rates in Detroit, Grand Rapids, Highland Park, and Saginaw. Each of those cities took action to levy taxes at rates higher than that authorized to other cities. Recent actions in Grand Rapids have ratcheted up the city income tax rate up and to conform with another amendment to the state law, Detroit reduced its income tax rate over several years.

Actions to scale back Detroit's income tax rate provide a lesson for any current and future efforts to scale back tax rates by instituting automatic tax rate reductions spread over several years. Because Detroit was taxing non-residents at 1.5 percent and residents at 3.0 percent, the income tax was seen as a disincentive for people to work or live in the city. In 1998, the Uniform City Income Tax Act provisions providing authority to levy the tax at higher rates were amended to automatically reduce the resident income tax rate 0.1 percentage points per year for 10 years. The rate on non-residents was to reduce in lockstep by 0.05 percentage points a year. When the process had fully played out, the new rates would become 2.0 percent for residents and 1.0 percent for non-residents.⁷

The 1998 amendment contained provisions that halted the process of tax rate reduction if certain unfavorable financial conditions occur. The safeguard provided for the suspension of the tax rate reductions, if any three

⁴ Public Act 94 of 2007.

⁵ Public Act 284 of 1964.

⁶ The 22 cities include: Albion, Battle Creek, Big Rapids, Detroit, Flint, Grand Rapids, Grayling, Hamtramck, Highland Park, Hudson, Ionia, Jackson, Lansing, Lapeer, Muskegon, Muskegon Heights, Pontiac, Port Huron, Pontiac, Saginaw, Springfield, Walker.

⁷ Public Act 500 of 1998.

of the following occurred:

1. Detroit had two consecutive years of withdrawals from the city's budget stabilization fund or exhaustion of the city's fund balance;
2. Detroit experienced a year-to-year decline in income tax revenue, after adjusting for inflation, of more than five percent;
3. Detroit had a city unemployment rate of ten percent or higher; or
4. Detroit experienced significant decline in its property tax base. The amendment contained a provision which compares the growth ratio of the city's taxable value with the comparable statewide figure and computes a ratio which must fall below 0.80 for the tax rate reduction process to stop. (In order for the ratio to fall below 0.80 with the state taxable value holding constant, the city's taxable value would have to decline 20 percent.)

The automatic tax rate reduction amendment played out for six years after enactment and then the safeguards halted the process in 2004. Worsening statewide economic conditions and Detroit's well documented economic struggles kept the safeguards applicable for several years following the halt. Ultimately the Uniform City Income Tax Act provisions pertaining to Detroit were again amended to freeze the scheduled rollback of tax rates for residents and non-residents.⁸ The amendment was part of a legislative package that

authorized the creation of a public lighting authority within Detroit to service and operate the municipally-owned lighting system. The act provided that if such an authority is created (which the Detroit City Council did in 2013), the revenue collected from 0.2 percent of the rate levied on residents and 0.1 percent of the rate levied on non-residents would be dedicated to the city's police department budget. Detroit's city income tax rates remain at 1.2 percent for non-residents and 2.4 percent for residents.

Future Changes

The state personal income tax rate stands to be reduced in the future because of a provision that was adopted as part of the road funding package enacted at the end of 2015. Beginning in tax year 2023, the personal income tax rate would be reduced by a calculated amount in any fiscal year for which cumulative general fund/general purpose (GF/GP) revenue growth between Fiscal Year (FY)2021 and the most recently completed fiscal year exceeded 1.425 times the cumulative rate U.S. Consumer Price Index inflation over the same period. The revenue effects from the rate reduction are specifically targeted to affect the GF/GP budget. The amendment aims to hold the School Aid Fund harmless from any tax rate reductions.⁹ The provisions do not return the tax rate to previously authorized levels if revenues in future years fall below the calculated amount tied to inflation.

⁸ Public Act 394 of 2012.

⁹ Public Act 180 of 2015.

Adequacy of Tax Revenues

It can be asked whether state tax revenues in general or revenues specifically from the state personal income tax are “adequate”. Adequate may connote different things to different people. Thus, this analysis uses three methods of evaluating adequacy from different perspectives:

1. Current revenues measured against historic tax revenues.
2. Current revenues measured against the constitutional tax limitation created by the Headlee Amendment.
3. Michigan tax revenues compared to other states.

Measuring against Previous Year Tax Revenues

Every government is unique and the residents and voters hold different values that are reflected by the government's programs and tax policies. For this reason, it is proper to measure the current amount of tax revenues against earlier revenue amounts generated by a given unit of government. This may be done both by looking at the nominal dollar amounts and taking into account the change in the price of government service provision (i.e., adjusting for inflation).

For purposes of assessing tax revenues, the following looks at total state tax revenues over time and, specifically, personal income tax revenues over time.

Total State Tax Revenues

State tax revenues in general tend to fluctuate with changing economic conditions. The package of taxes used to generate tax revenues to fund state and local government programs can evolve over time. It is possible to decipher the overall trend of revenues by looking at total tax revenues. This comparison looks at tax revenues since the Headlee Amendment to the state Constitution was adopted in 1978.

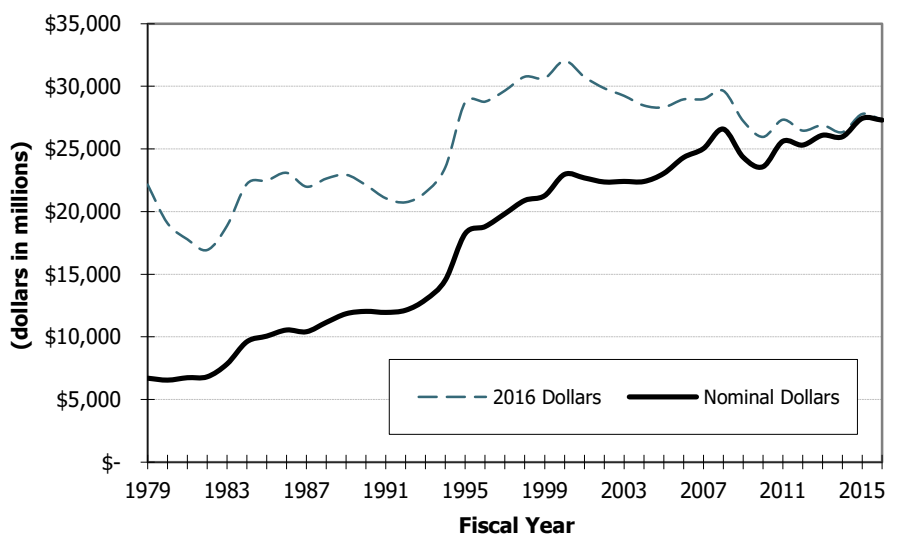
As seen in **Chart 2**, FY2016 nominal tax revenues of \$27.3 billion were slightly more than the previous high point of \$26.6 billion in FY2008. Total state tax revenues were on a fairly consistent growth path from adoption of the Headlee Amendment in 1978 until the beginning of Michigan's single state recession in 2001. The effect of the single state recession on the state's revenues is clearly evident in the most recent years on the chart.

When total tax revenues are adjusted for inflation to take into account the change in price of government services over time, it becomes evident that FY2015 revenues were 13.2 percent less than the FY2000 peak of \$31.6 billion. Following that peak, state tax revenues declined throughout the first decade of the 2000s and then dropped further as a result of the Great Recession that occurred from late in 2007 to early in 2009. When adjusting for inflation, FY2015 tax revenues were at levels last seen in FY1995 (except on the way down in FY2009).

Personal Income Tax Revenues

Michigan personal income tax revenues were on a fairly constant growth path from the time of their adoption in

Chart 2
Total State Tax Revenues, FY1979 – FY2016



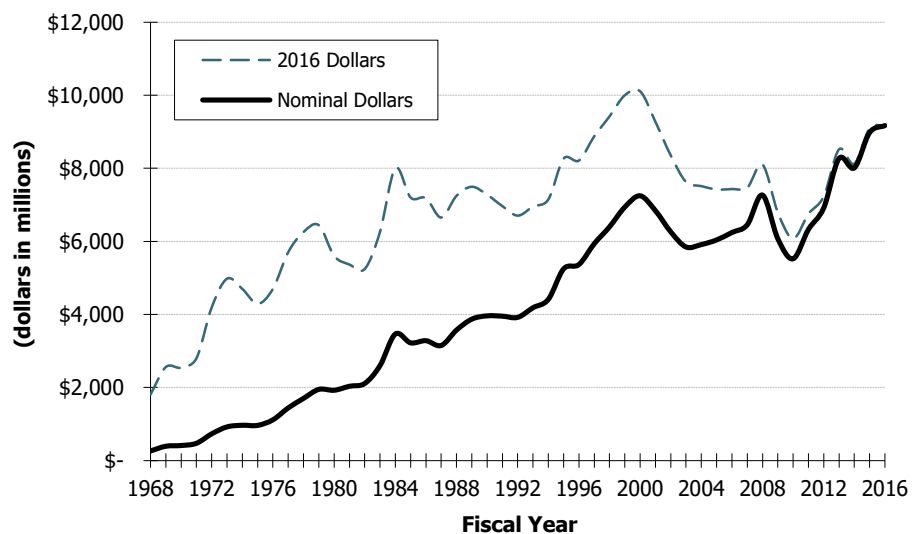
Source: Michigan Department of Treasury, CRC calculations to adjust for inflation using U.S. CPI-U as determined by the U.S. Department of Commerce.

PERSPECTIVES ON MICHIGAN'S STATE PERSONAL INCOME TAX

until the start of Michigan's single state recession in 2001. After experiencing some fairly large swings in the decade that followed, Michigan income tax revenues have been on a growth path in the past five years. FY2016 income tax revenue of \$9.2 billion were higher than the FY2008 peak of \$7.3 billion or the FY2000 peak of \$7.2 billion (See **Chart 3**).

However, the \$9.2 billion collected in FY2016 is still 10 percent less than the inflation-adjusted FY2001 peak of \$10.0 billion. When adjusting for inflation, FY2015 income tax revenues were at levels last seen in FY1997 (except on the way down in FY2001). The inflation-adjusted trend line in **Chart 3** shows with greater clarity how income tax revenues have been susceptible to changing market conditions and tinkering with the tax rate.

Chart 3
Personal Income Tax Revenues, FY1968-FY2016



Source: Michigan Department of Treasury, CRC calculations to adjust for inflation using U.S. CPI-U as determined by the U.S. Department of Commerce.

Measuring against the Constitutional Revenue Limit

As Michigan's answer to the nationwide tax revolt experienced in the 1970s, in 1978 voters adopted a series of amendments to Article IX of the Michigan Constitution commonly referred to as the Headlee Amendment. Pertinent to this discussion, the amendment that added Section 26 to Article IX created a state revenue limit. The amendment created the limit as a ratio of state revenue collected to personal income measured in that fiscal year. This ratio, presented as a percentage, was calculated to be 9.49 percent of personal income in 1978. The Headlee revenue limit, as it is commonly referred to, is fixed at 9.49 percent for each year.¹⁰

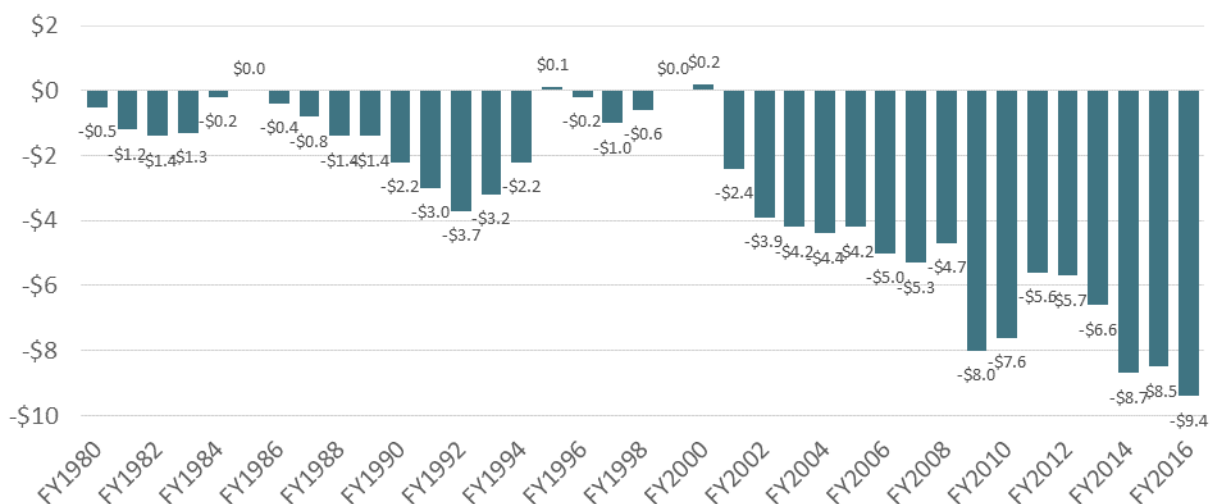
Michigan revenues hovered not far from the revenue limit for 20 years following the adoption of the Headlee Amendment. Changes in tax policy, such as the shift in taxing responsibility from the local school districts to the state as part of Proposal A in 1994 kept the state close to the revenue limit.

The advent of Michigan's single state recession beginning in 2001 caused the state to fall far below its revenue limit. By FY2009, the state was \$8.0 billion below the revenue limit and by FY2016 the state was \$9.4 billion below the limit. Current total tax revenues flowing into the GF/GP budget of \$8.5 billion are less than half of the revenues the state is permitted under the revenue limit.

10 The state revenue limit is focused on state-generated revenues (taxes, fees, charges, etc.). In calculating the limit, various categories of resources used to finance state appropriations are excluded, including federal aid, bond proceeds, special Medicaid reimbursements, debt service.

Chart 4

Michigan Revenue Relative to Constitutional Revenue Limit, FY1980-FY2016



Source: House Fiscal Agency, State Budget Overview, January 2015, www.house.mi.gov/hfa/archives/pdf/state_budget_overview_jan2015.pdf

Table 1

Michigan Total State and Local Government Tax Collections as Percent of U.S. Average

Year	U.S. Average		Michigan					
	Per Capita	Per \$1,000 Personal Income	Amount	Per Capita		Per \$1,000 Personal Income		
				As Percent of U.S. Average	Rank	Amount	As Percent of U.S. Average	Rank
1983	\$2,847	\$96.21	\$3,213	112.8%	12	\$112.52	117.0%	9
1993	3,686	105.38	3,785	102.7	14	111.23	105.6	13
2004	4,256	100.57	4,106	96.5	25	103.73	103.1	17
2008	4,731	106.43	4,096	86.6	30	105.65	99.3	19
2012	4,483	99.82	3,719	83.0	34	94.83	95.0	32
2013	4,599	103.49	3,750	81.6	35	95.68	92.5	34

Sources: Population data are from intercensal estimates by the U.S. Census Bureau obtained from the U.S. Bureau of Economic Analysis. Personal income data are from the U.S. Bureau of Economic Analysis.

Per capita amounts have been adjusted to 2013 dollars using the calendar year U.S. CPI-U.

Measuring Michigan against Other States

Total State Tax Revenues

In 2013, Michigan ranked 35th highest in the U.S. at \$3,750 of total state and local government tax revenue per capita. Michigan was 34th highest in the nation with \$96 of total tax revenues per \$1,000 of personal income. Michigan's ranking against other states decreased by 21 places, mirroring the national shift toward lower taxation in the past two decades (see **Table 1**).

Total state and local government tax revenue increased from \$3,213 per capita in 1983 to \$4,096 per capita in 2008 (\$883 per capita increase), but has since declined to \$3,750 in 2013 (\$346 per capita decrease). The net change from \$3,213 to \$3,750 per capita in the past 20 years equates to a \$537 per capita increase, whereas the U.S. average amount in the same time has increased by \$1,751 per capita. Michigan's per capita state and local government tax revenues leaves it at 82 percent of the national average in 2013. Similarly, Michigan's total tax revenue per \$1,000 of personal income went from above average in 1983 to below average since 2008. It was 92.5 percent of the

national average in 2013.

Comparing Michigan's total per capita state and local tax revenues to the rest of the country shows Michigan was similar to Montana, Louisiana, Indiana, New Mexico, Arkansas, and North Carolina. New England and mid-Atlantic states, as well as some of the Upper Plains states, had relatively higher tax burdens, whereas the Southeastern states tended toward lower tax burdens (See **Map 1**).

In terms of state and local government total tax rev-

Map 1

State and Local Government Tax Revenue per Capita as Percentage of U.S. Average, 2013, by Ranking

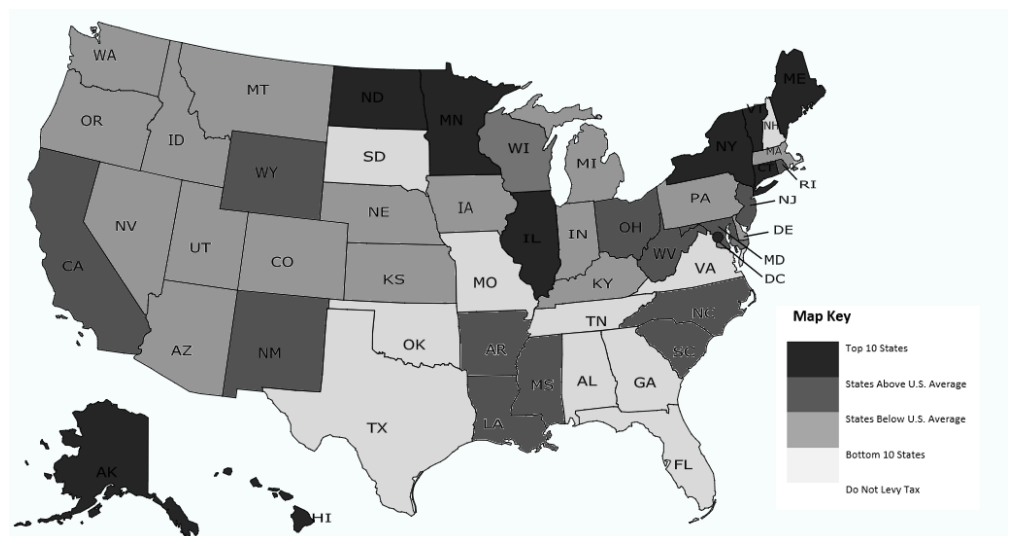


Table 2
State and Local Government Individual Income Tax Revenues

Year	U.S. Average		Michigan					
	Per Capita	Per \$1,000 Pers. Income	Amount	Per Capita		Per \$1,000 of Personal Income		
				As Percent of U.S. Avg.	Rank	Amount	As Percent. of U.S. Avg.	Rank
1993	\$764	\$21.85	\$886	115.9%	18	\$26.03	119.1%	16
2004	906	21.42	780	86.1	32	19.71	92.0	34
2008	1,085	24.41	831	76.6	34	21.44	87.9	34
2012	992	22.10	754	76.0	34	19.23	87.0	34
2013	1,069	24.07	866	81.0	34	22.10	91.8	34

N/A - The U.S. Census Bureau did not segregate individual income and corporate income tax revenues in 1983.

Source: U.S. Census Bureau, www.census.gov/govs/local/.

enues per \$1,000 of personal income, Michigan was similar to Nevada, Montana, Kentucky, Utah, North Carolina, Washington, Arizona, Louisiana, and Colorado. Again, states in New England and the Upper Plains tended to have higher tax burdens. Lower tax burdens were distributed through some parts of the Plains, South, and Southwest. North Dakota, Alaska, Louisiana, and Wyoming benefited from oil and gas extraction taxes. (See **Map 1**.)

Michigan ranked below all other Great Lakes states in both measures of overall tax burden.

Personal Income Tax Revenues.

Michigan's personal income tax revenue burden ranked 34th in the nation on both a per capita basis and as a percentage of personal income. Collections for 2013 equaled \$866 per capita, 81 percent of the national average, and \$22 per \$1,000 of personal income, 92 percent of the national average (see **Table 2**).

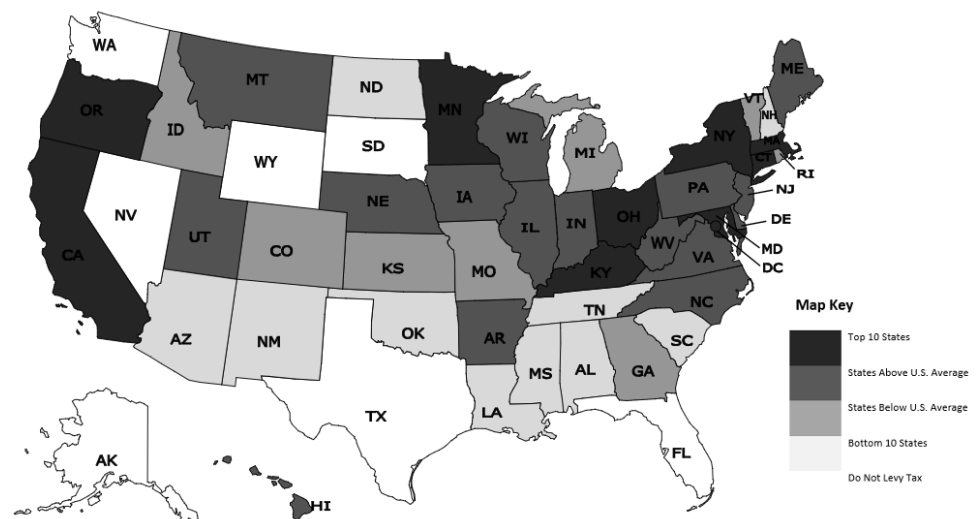
Throughout the 1980s and into the 1990s, Michigan had a relatively high income tax burden under both measures of tax burdens, owing in part to its status as a high-income state during that period. Even as the state's economic conditions

worsened, the state remained among the top 20 states in terms of income tax burden through the end of the 1990s. In the early 2000s, Michigan's weak economy, along with income tax rate reductions, resulted in reduced revenues, and Michigan fell to 34th in income tax burden by 2008 and remains there five years later. From 2012 to 2013, while Michigan's ranking remained the same, both national and state income tax revenues increased, with Michigan's increase more pronounced than the national average using both measures of impact.

Revisions to Michigan's personal income tax law brought about extensive changes for returns filed in 2013 that significantly increased revenue collec-

Map 2

State and Local Government Personal Income Tax Revenue per \$1,000 of Personal Income as Percentage of U.S. Average, 2013



tions. While the income tax rate itself was reduced to 4.25 percent, a large number of previously available exemptions were eliminated. Most notably, exemptions for certain pension and retirement income were significantly limited, leading to a large expansion of the tax base. However, the changes also included the elimination of many other special exemptions targeted to seniors, children, public contributions, auto donations, and tuition and fees for colleges and universities. Furthermore, the state's Earned Income Tax Credit was reduced from 20 percent to 6 percent of the related federal credit, and changes to the homestead property credit resulted in significantly reduced credit amounts for many claimants. These changes led to a significant increase in state personal income tax collections, even though the overall rank of the state compared to other states in the nation did not change¹¹

In 2013, states along both the East and West Coasts tended to have higher income tax burdens, as did a number of Midwestern states with Minnesota, Ohio, and Kentucky all falling within the nation's top ten in terms of income tax burden (see **Map 2**). States in the South had comparatively low income tax burdens. Seven states – Texas, Florida, Nevada, Wyoming,

South Dakota, Washington, and Alaska – did not levy a personal income tax.

Tax Rates

The application of a personal income tax is complicated in many ways, making interstate comparisons of those taxes equally complicated. States differ in the tax rates applied – flat rate or progressive tax rates with multiple brackets; the states with progressive income taxes vary in the number of brackets; although most states start with adjusted gross income (AGI) calculated for federal tax purposes, the tax base often varies among states because of exemptions, deductions, and credits.

Personal income taxes are levied in 43 states. Of these, 41 tax wage and salary income, while two states – New Hampshire and Tennessee – only tax dividend and investment income. The other seven states levy no income tax at all.

Michigan is one of eight states that levy a flat rate tax on individuals. Article IX, Section 7 of the 1963 Michigan Constitution specifies that neither the state nor any of its subdivisions may levy an income tax graduated as to rate or base.

When using the tax rates applied to the highest income

11 Public Act 38 of 2011.

brackets as a basis for ranking states, Michigan's 4.25 percent tax rate is relatively low. Only five states – North Dakota, Pennsylvania, Indiana, Illinois, and Wisconsin – levy lower tax rates on individuals in the highest income brackets (see **Chart 5**).

California levies the highest tax rate on individuals in the highest tax bracket: 13.3 percent on single filers with income of \$1 million or more and on married filing jointly filers with income of \$1,052,886. The state divides taxpayers into 10 tax brackets with a 1 percent tax levied on individuals in the lowest tax bracket.

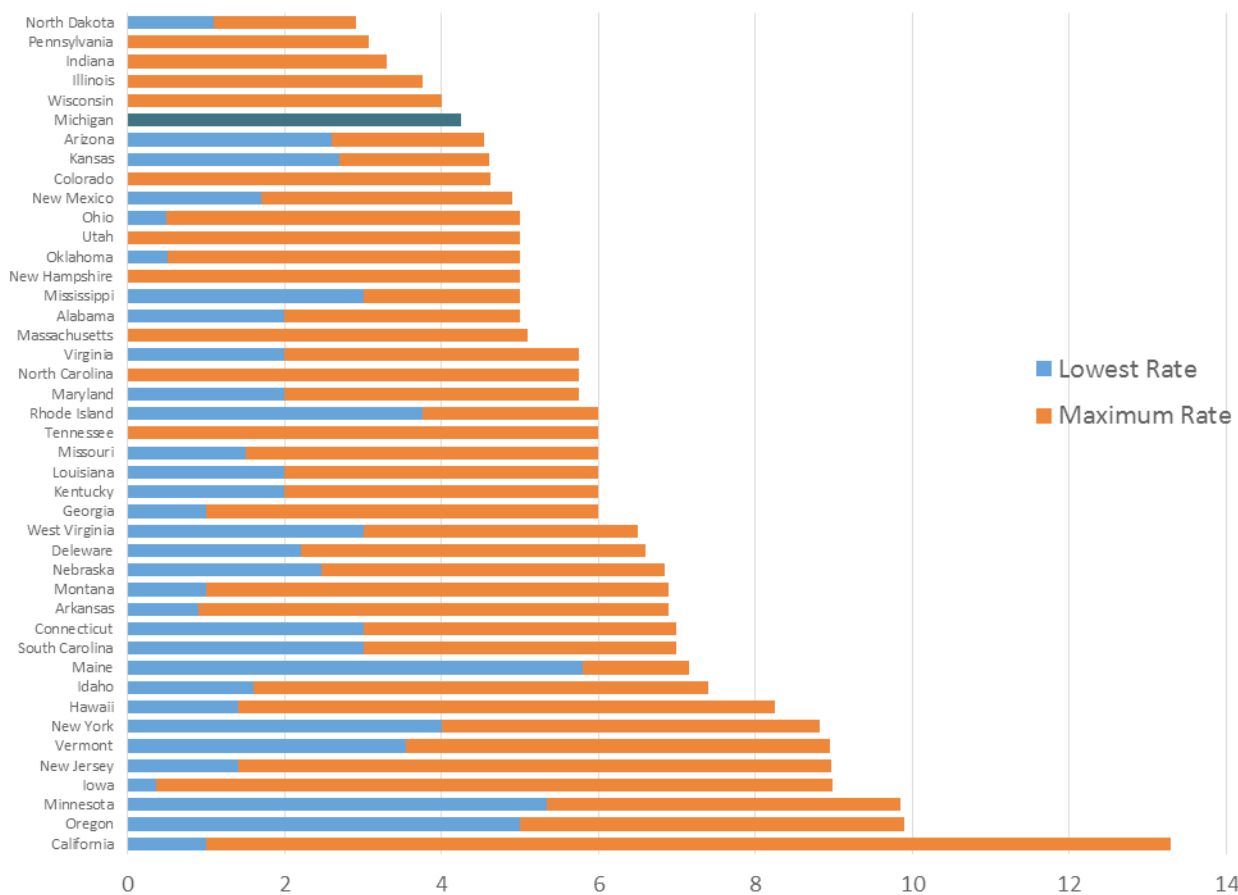
Oregon (9.9 percent) and Minnesota (9.85 percent) also levy relatively high tax rates on individuals in

their highest tax brackets. Each of these states divide their taxpayers into four tax brackets and each has much lower thresholds for the highest tax bracket than does California. (While California's highest tax brackets apply to single filers with income of \$1 million or more and married filers with income of \$1,052,886 or more, Oregon's top bracket applies to single filers with income above \$155,650 and married filing jointly filers above \$259,420 and Minnesota's highest bracket applies to single filers with income above \$125,000 and married filing jointly filers above \$250,000). The tax rates levied on individuals in the lowest tax brackets in these states (Oregon 5.0 percent, Minnesota 5.35 percent) is higher than the flat rate tax levied on all incomes in Michigan.

Chart 5

State Personal income tax Rates

(rates applied to lowest and highest tax brackets in states with progressive systems)



Source: Tax Foundation, *State Personal Income Tax Rates and Brackets for 2015*, <https://taxfoundation.org/state-individual-income-tax-rates-and-brackets-2015/>.

Reliance on Personal Income Tax Revenues in Other States

State and local government tax systems are often measured against an ideal in which three tax components – property, sales, and income taxes – contribute roughly equally to the total. Economists argue that this “three-legged stool” model of taxation provides the optimal state tax system, minimizing deadweight loss from inefficient taxation and reducing distortionary effects on the economy. Several states omit or emphasize a component of this tax model in order to shore up certain parts of their economy or take advantage of certain business patterns. For instance, Florida, by relying on tourism to generate a substantial portion of its revenues, has been able to use the sales tax to export a portion of the tax burden to outsiders (i.e., tourists) and thus has not needed to levy personal income taxes. Similarly, states like Texas and Wyoming offset their lack of corporate and income taxes, designed to spur corporations and people to move to those states, with higher sales and property taxes. Alaska, Texas, and Wyoming each benefits from revenues produced for the extraction of natural resources.

In terms of volatility, income tax revenues are most responsive to changes in the business cycle, increasing significantly during economic expansions and shrinking during recessions. Sales tax revenues are slightly less responsive, while property tax revenues – being dependent on property values rather than income – are by far the least responsive to economic conditions. As such, property taxes can insulate a state’s revenue stream from the effects of a recession better than income or sales taxes. At the same time, reliance on property tax results in a smaller increase in the amount of gross tax receipts during times of growth.

In 2013, Michigan collected 95 percent of its tax revenues from the three major tax components outlined above in one form or another (see **Table 3**). The remaining portion of tax revenue comes from other tax levies, including beverage licenses, hunting and fishing licenses, and motor vehicle licenses. The portion of tax revenue collected from outside the three major groups of taxes in Michigan has historically been at about five percent, or two to three percentage points less than the national average (7.7 percent in 2013).

The composition of the revenue collected from the three major tax groups in Michigan has evolved over the last several decades, and continues to do so, given the large-scale changes to the Michigan tax structure in the past several years. Thirty years ago, Michigan favored lower sales taxes and greater reliance on property and income taxes. With the tax shifts associated with Proposal A of 1994, the move from the Single Business Tax to the Michigan Business Tax and then the Corporate Income Tax, and Michigan’s economic malaise, the major contributor of tax receipts shifted from property taxes to sales taxes, with the income tax share also becoming markedly reduced over the last several decades.

The decline in the share of revenue coming from the income tax was only partially the result of personal income reductions in Michigan during the 2000s. Part of the decline resulted from the methods used by the U.S. Census Bureau in reporting Michigan’s business tax revenue. All of Michigan’s former Single Business Tax revenue was designated as income tax revenue by the Bureau, but only 30 percent of Michigan Business Tax revenue was designated as corporate income tax. For

this reason, the decline is overstated to a degree. Likewise, the sales tax proportion was drastically inflated, because 70 percent of Michigan Business Tax revenue was as-

Table 3
Michigan’s Distribution of Taxes as a Percent of Total State and Local Taxes, 1993-2013

<u>Year</u>	<u>Property</u>	<u>Sales</u>	<u>Income</u>	<u>Other</u>
1993	41.29%	21.82%	31.63%	5.26%
2008	37.55%	32.38%	25.02%	5.05%
2012	36.65%	35.69%	22.50%	5.17%
2013	35.21%	33.87%	25.51%	5.41%
2013 U.S. Average	31.29%	34.11%	26.90%	7.70%

Source: U.S. Bureau of Economic Analysis and U.S. Census Bureau.

signed to the general sales tax to account for the gross receipts component of the tax.

Between 2012 and 2013, however, the tax composition became more balanced across the three categories, with income taxes as a proportion of receipts increasing, and the sales and property tax shares decreasing slightly. This occurred despite a reduction in personal income tax rates and increases in the personal exemption from tax law changes that eliminated exemptions for certain pension and retirement income and reduced a number of prominent credits in 2012. These changes became effective in 2013.¹²

States that Vary from the Ideal

As mentioned earlier, seven states – Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming – do not levy a personal income tax at all and two states – New Hampshire and Tennessee – only tax dividend and investment income. On the other hand, five states – Alaska, Delaware, New Hampshire, Montana, and Oregon – do not levy a state sales tax.

The ability of states to stray from the norm rests on the economic drivers of their states and the tax policy priorities each state has in place. Florida and Nevada benefit heavily from the tourism industries that drive their state economies and each receives more than half of the state tax revenues from sales tax revenues. South Dakota, Texas, and Washington benefit less from tourism, but each receive more than half of their state tax revenue from the sales tax. Alaska, Texas, and Wyoming benefit greatly from the oil and mineral extraction that are significant parts of their state economies. The Alaska Permanent Fund pays people to live in Alaska, rather than taxing them based on their economic activity.

It is worth noting that each of these states has experienced difficult budgetary decisions as economic winds have shifted against them from time to time. Florida's and Nevada's budgets were stressed by the effect of the foreclosure crisis and the impact on property values. Washington, with a manufacturing sector comparable to Michigan's, has had to make difficult decisions during recessionary periods. And states that rely on revenue from the extraction of natural resources are beholden to international markets for the prices of those commodities.

12 Michigan Department of Treasury, *Income Tax Changes for Individuals and Trusts Effective Tax Year 2012*, https://www.michigan.gov/documents/taxes/Tax_Change_Summaries_-_Individual_Income_Tax_359807_7.pdf

Role of Michigan's Personal Income Tax

If the personal income tax goes away:

1. Can revenues from existing taxes grow at sufficient rates to make up for the loss?
2. Where will replacement revenue come from?
3. What will be the state budget reductions to ensure budget balance?

As is evident in **Chart 6**, the personal income tax and the sales and use taxes are the primary sources of tax revenues for the state government. These three taxes contribute nearly 75 percent of the state's tax revenues. Other tax revenues flow from sin taxes, such as tobacco and liquor, business taxes, such as the Corporate Income Tax and the insurance company tax, and the State Education Tax.

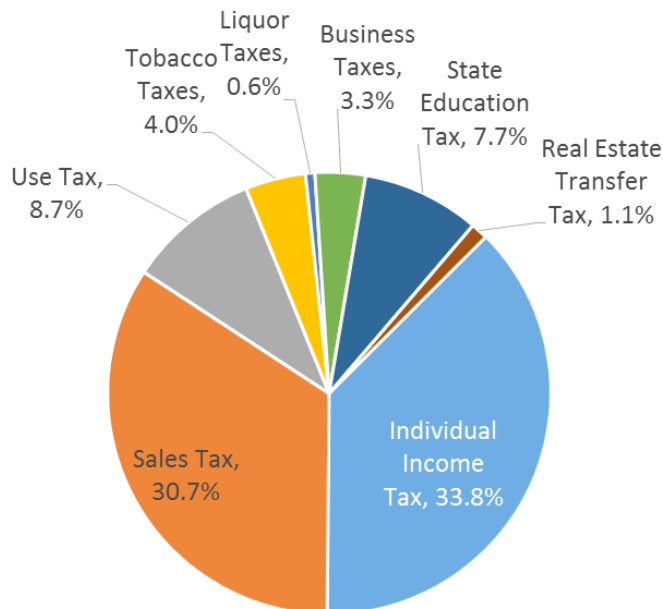
General Fund/General Purpose Budget

The overall state budget is divided into several sub-budgets. The primary budgets include the general fund/general purpose (GF/GP) budget, the School Aid Fund, and the Transportation budget. The School Aid Fund and the Transportation budget each have revenues constitutionally and statutorily earmarked for deposit directly into them and each is intended to fund specific services.

The GF/GP budget funds all functions and services for which there are no dedicated sources. State policy-makers must prioritize spending needs according to the revenues available to pay for those needs. It receives more than 72 percent of the revenue from the personal income tax (see **Chart 7**). Other revenues are derived from the undedicated portion of the sales, use, and tobacco taxes and from business taxes. As described below, a portion of the personal income tax revenues are dedicated to the School Aid Fund and that dedication is structured in such a way that the GF/GP budget will absorb changes in the income tax rate and the School Aid Fund will be unharmed.

Chart 6

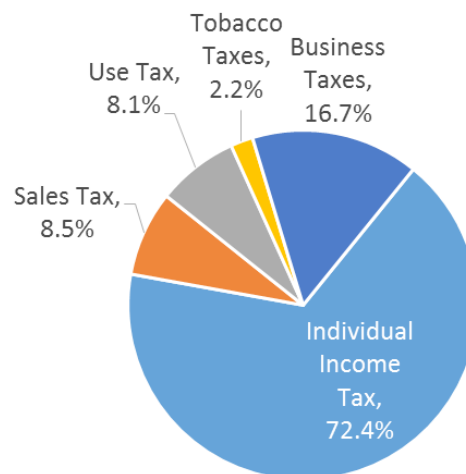
Major Sources of Michigan State Tax Revenue, FY2015



Source: 2014-15 Annual Report of the Michigan State Treasurer, www.michigan.gov/documents/treasury/State_Treasurers_Annual_Report_2014-15_524479_7.pdf.

Chart 7

Major Sources of Michigan General Fund/General Purpose Budget Revenues, FY2015



Source: 2014-15 Annual Report of the Michigan State Treasurer, www.michigan.gov/documents/treasury/State_Treasurers_Annual_Report_2014-15_524479_7.pdf.

Options if the Income Tax is Reduced or Eliminated

The prospects for reducing or eliminating the state personal income tax must be considered in light of the Michigan Constitution's mandate for a balanced budget. If the state personal income tax rate is reduced or the tax is eliminated, policymakers can consider several options to address the revenue decline from this source:

1. They can rely on existing tax sources to grow at sufficient rates to make up for revenues lost from the income tax,
2. They can adjust the tax rates levied on other taxes to generate revenues that would replace lost income tax revenues, or
3. They can cut spending as revenues decline to keep spending in line with available resources.

Each option includes complications. Provisions in the Michigan Constitution or state law affect the use of tax revenues and tax rates that may be applied. Appropria-

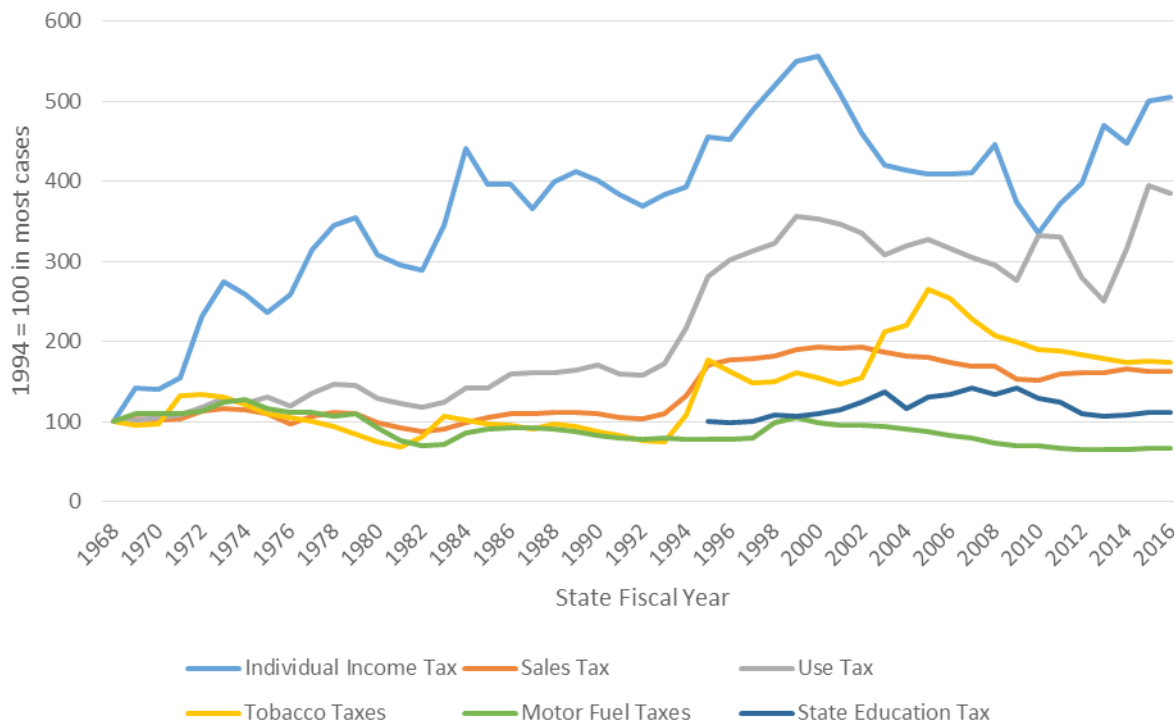
tions reductions in some areas will result in more than a dollar-for-dollar decline in spending because of federal matching requirements that may not be matched. And because of the nature of how state tax dollars are used, reductions in state resources will stand to affect school districts, community colleges and universities, local governments, hospitals and other health providers, and many other public and private entities that receive state funding to carry out public purposes.

Replacement from Existing Tax Sources

To assess whether the growth of existing taxes flowing into the GF/GP budget may be sufficient to make up for reductions in the personal income tax rate, tax revenues for major taxes have been indexed to measure their growth since Proposal A of 1994 was adopted. **Chart 8** does not attempt to adjust for revenue growth related to changes in tax rate or adjustments to the tax base. Business taxes are omitted because of the transition from the Single Business Tax, to the

Chart 8

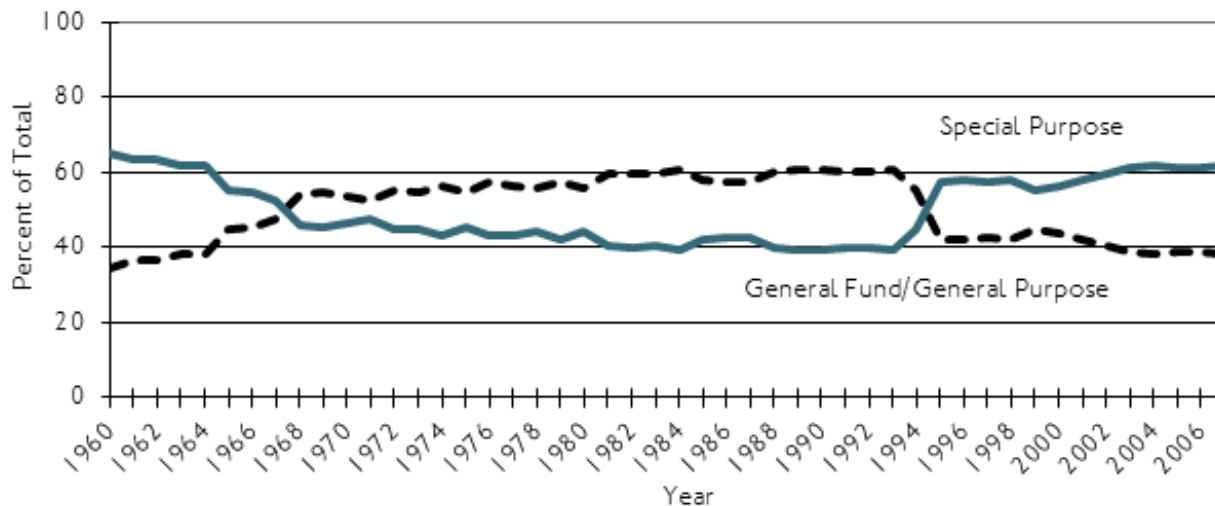
Measuring the Growth of Select Major State Taxes, FY1968-FY2016



Source: Report of State Treasurer, Michigan Department of Treasury, various years. Citizens Research Council of Michigan calculations.

Chart 9

Earmarked State Tax Revenues as a Percent of All State Tax Revenues, 1960-2006



Michigan Business Tax, to the Corporate Income Tax during this period.

Chart 8 shows that none of the taxes flowing into the GF/GP budget have been very robust since 1994. The individual income, sales, and use taxes experienced some growth in the late 1990s. That growth was washed away during the first decade of this century, more so for the personal income tax than for the sales and use taxes. Tobacco tax revenue experienced several peaks during the period in question driven by changes to the tax rates applied to tobacco products. Based on past experience, there is little prospect of revenue from existing taxes growing at sufficient rates to make up for lost income tax revenue.

Earmarking

The idea that the growth of existing tax revenues could be sufficient to make up for reduced income tax revenue is further complicated by Michigan's heavy reliance on earmarking. Earmarking, or dedicating, refers to the practice of reserving revenue from specific sources for specific functions. It takes two forms: 1) a fixed dollar amount of the revenue generated from a given source; or 2) a fixed percentage of the revenue from a given source.

Michigan is among a few states that rely heavily on the practice of earmarking state tax revenue to specific purposes. While this practice safeguards funding for

select public services from changing political climates, earmarking encumbers the ability of state lawmakers to carry out the task of fiscal planning and stewardship that is most essential among their job responsibilities.

A substantial amount of the state's financial resources are already allocated to specific purposes before Michigan lawmakers begin the annual budgeting process. Of the total \$53 billion State of Michigan FY2015 spending plan, almost 42 percent is financed by federal funds that were directed to specific purposes and over which state officials have little or no discretion.¹³ While the remainder of the budget is financed by state revenues, including various taxes and fees, a hefty portion is designated for specific functions or programs either by the state constitution or statute.

Following the adoption of the 1963 state constitution, two seemingly contradictory trends occurred with the disposition of state tax revenues. First, after the framers reduced the amount of constitutional earmarking, many of the new taxes enacted during the subsequent three decades included earmarking provisions. The second trend was that earmarked revenues did not grow as a percent of total state tax revenues (see **Chart 9**). In 1965, approximately 55 percent of the

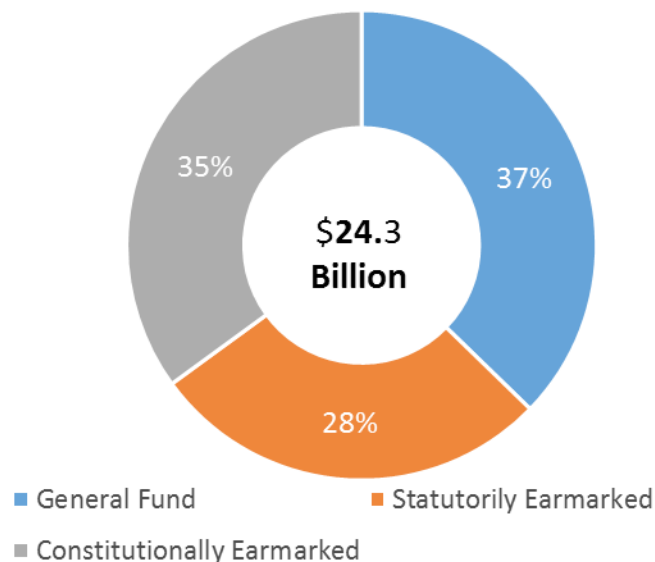
¹³ Senate Fiscal Agency, *FY2014-15 Appropriations Report*, August 2014. www.senate.michigan.gov/sfa/Publications/Approps/Initial2014.pdf

total tax yield was earmarked to specific functions. As a share of the total, earmarked revenues fell gradually over the next 15 years to about 40 percent of the total in 1980. The amount of dedicated revenue remained at this level for the next 15 years until the adoption of the Proposal A school finance reforms in 1994. These two trends suggest that during the three decades immediately following the adoption of the new constitution, the amount of dedicated taxes did not grow as a share of the total tax generated, but this was not the result of lawmakers' deciding to earmark fewer taxes.

Chart 10 shows the distribution of total state tax revenues between the General Fund and earmarked funds in FY2014. In FY2014, nearly 63 percent of the total was earmarked (\$15.3 billion). On a total state tax basis of \$24.3 billion in FY2014, this represented an additional \$1.3 billion in earmarked revenues.

Among existing state taxes, general sales and use taxes produce the sums large enough that making up for lost personal income tax revenue could be contemplated. This includes not only the general sales and use taxes, but also a number of excise and selective sales taxes. In total, these taxes generated \$9.9 billion in FY2014, with nearly 90 percent raised by the 6 percent sales tax (\$7.2 billion) and the 6 percent use tax (\$1.6 billion). Both taxes are heavily earmarked. Nearly 90 percent of sales tax revenue goes to specific functions, mainly the School Aid Fund and local government revenue sharing. Currently, one-third of the use tax revenue is deposited to the School Aid Fund with the remainder going to the General Fund. Earmarking of the Use Tax will increase over the coming years as a result of the personal property tax changes enacted in 2014. The majority of the revenue from many of the selective excise taxes (e.g., alcohol, tobacco) is earmarked. For these taxes in total, approximately two-thirds of the

Chart 10
Distribution of State Tax Revenues, FY2014



revenue is dedicated.

Bottom Line

Economic expansion that may come from reduced taxes faces two hurdles before it can replace lost income tax revenue. First, Michigan's consumption taxes do a poor job of connecting with the state's economy. While the economy has become increasingly service-oriented, the state sales and use taxes are oriented toward the sale of tangible goods. As a result, the sales and uses taxes will capture only a fraction of new economic activity that might result from the elimination of the income tax.

Further, because of the state's heavy reliance on earmarking, the taxes that would be the prime candidates to produce revenues sufficient to replace foregone income tax revenue would funnel gains in revenues away from the general fund. Money not paid as income taxes that is used for increased purchases would result in more funding for the School Aid Fund and state revenue sharing, with only about 10 cents of every new dollar of revenues flowing to the general fund. New

PERSPECTIVES ON MICHIGAN'S STATE PERSONAL INCOME TAX

economic activity taxed via the use tax would result in more funding for the School Aid Fund and for personal property tax reimbursement, with only about 33 cents of every dollar flowing to the general fund.

Tax Increases

The personal income tax has proven to be a robust source of revenue for the state. Replacing revenue from that tax with new taxes or increases in tax rates on existing taxes would not be easy. Generally, sales and property taxes are the only other taxes capable of raising large sums of revenue (in the magnitude of the current state personal income tax).

General Sales Tax

Increase the Rate. Increasing the sales tax rate is complicated by Michigan's constitutional restriction on the rate. Article IX, Section 8 of the 1963 Michigan Constitution says that "... the Legislature shall not impose a sales tax on retailers at a rate of more than 4% of their gross taxable sales of tangible personal property..." It goes on to specify that "the sales tax shall be imposed on retailers at an additional rate of 2% of their gross taxable sales of tangible personal property..." These provisions combine to require the state to levy a two percent sales tax and permit it to levy an additional four percent tax, but it is restricted from exceeding six percent.

To overcome this obstacle would require a constitutional amendment.

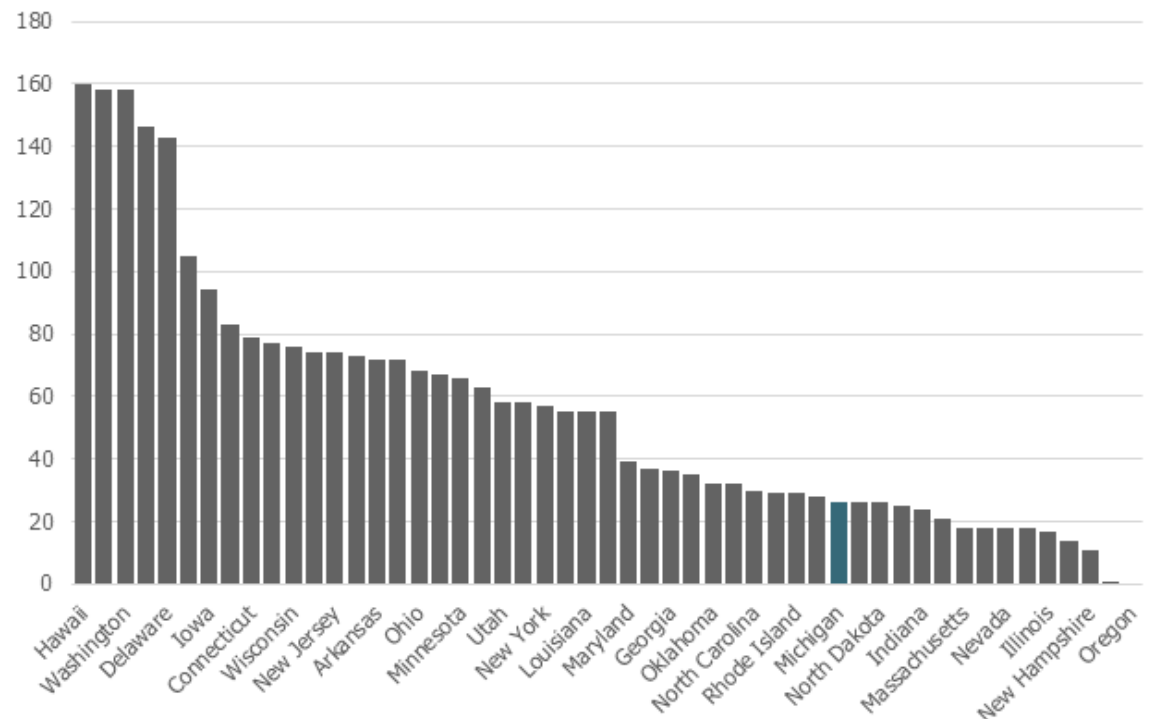
Expand the Base. The connection between Michigan's economy and the state government's tax structure

has weakened since the late 1990s. As a consequence, the growth in revenues from the major taxes has lagged behind general measures of the Michigan economy. Three measures of the economy often used to help predict tax revenues are total personal income, disposable personal income, and total payrolls. Total personal income is the total of all sources of income for all individuals in the state. Disposable personal income is personal income minus taxes. Total payrolls are the wages and salaries before taxes paid to individuals in the state. All three indicators have their limitations in measuring the overall performance of the economy, but one would expect the performance of taxes on income and consumption spending to exhibit similar rates of change to the income measures, unless other factors are at play.

Michigan's major consumption taxes on the sale and use of tangible property and a limited number of services do not connect effectively with our ever-increasing service-oriented economy. Services have grown faster and are likely to continue to grow faster

Chart 11

Number of Services Taxed in Each State, 2007



Source: Number of Services Taxed by Category and State - July 2007, Federation of Tax Administrators, <https://www.taxadmin.org/number-of-services-taxed-by-category-and-state---july-2007>.

than other areas of the economy. The Bureau of Economic Analysis in the U.S. Department of Commerce reports that services constituted 11 percent of gross state product in Michigan in 1977 and had grown to over 20 percent by the turn of the century. In 2015, services constituted more than twice the share of the Michigan economy than it did at the turn of the century.¹⁴ Without recognizing growth of the service sector in today's economy, the state faces an increasing disconnect between the economy and revenues.

A survey of the states by the Federation of Tax Administrators reveals Michigan to be in the bottom quarter of all states in the number of services subject to taxation (see **Chart 11**).¹⁵ Services that could be subject to taxation include a broad array of activities purchased by consumers and businesses. They include medical services, such as visits to a physician; recreational and entertainment activities, such as movies and sports events; personal services, such as hair care; repair services, such as automobile repairs; professional services, such as tax preparation and legal services; and services for the home, such as lawn care. The failed attempt to include services in the sales and use tax bases in 2007, demonstrated that the selection of services to be included in the tax base is very important and very sensitive.

The effect on the tax base of including all services would be substantial, since the dollar value of services not taxed exceeds the dollar value of the goods and services currently taxed. A reconstituted tax base with a significant services component would grow faster than the current sales and use tax bases, since expenditures for services are expected to continue to grow faster than spending for goods.

The Michigan Department of Treasury estimates that more than \$12 billion of tax revenues are foregone because of the exemption of services.¹⁶ It is likely that an expansion of the sales tax base would not yield this much new revenue because some of the services

counted for this calculation include those provided by not-for-profit organizations, medical services, and other services that policymakers would likely (or be likely to) exclude because of the nature of the service or the nature of the service provider.

As discussed above, any desire to replace income tax revenues with an expanded sales tax also would be restricted by earmarking of the sales tax revenue. The tax rate would have to be increased significantly high without altering the earmarkings, or the earmarkings amended, to raise new general fund dollars with this tax source.

Amending the sales tax earmarking would require a constitutional amendment.

Economic Impact. Sales taxes tend to be regressive, placing a greater burden on low-income groups than groups with higher incomes. Efforts to reduce the regressive nature of the tax usually involve exempting items from taxation. In Michigan, sales of food not meant for immediate consumption and prescription drugs have been exempted from taxation to reduce the regressiveness. Some other states exempt clothing purchases below a certain price. Exemptions such as these achieve their goals of providing tax relief to low income groups, but they tend to create issues of horizontal equity wherein two individuals of equal income can be taxed at different levels due to differences in consumption preferences. The sales tax perhaps best illustrates the potential conflict policymakers must struggle with in attempting to balance horizontal and vertical equity.

In general, sales taxes provide a high level of horizontal equity, meaning that individuals of similar circumstances are treated equally by the tax code. This equity is eroded with provisions exempting items from taxation. Article IX, Section 8, of the Michigan Constitution exempts sales of "Prescription drugs for human use, or on the sale or use of food for human consumption..." Under these circumstances, an individual that likes to cook will make a larger share of their purchases from a market, where food is exempt from taxation in Michigan, than would an individual that prefers to eat in restaurants, where food is subject to the sales tax. These and other exemptions to the tax base lessen the level of horizontal equity associated with the sales tax.

14 www.bea.gov/

15 www.taxadmin.org/fta/pub/services/services.html.

16 *Executive Budget Appendix on Tax Credits, Deductions, and Exemptions; Fiscal Years 2016 and 2017*, Michigan Department of Treasury, https://www.michigan.gov/documents/treasury/ExecBudgAppenTaxCreditsDedExempts_FY_20152016_476553_7.pdf.

Sales taxes tend to be regressive because low income groups must use a larger percentage of their income to pay the tax than purchasers with higher incomes. A 1980 study by Donald Phares found that Michigan's exemption of food and prescription drugs makes Michigan less regressive than the national average.¹⁷ James Poterba argues that the level of regressiveness in the sales tax is further reduced if purchasing is analyzed over a lifetime, instead of as a snapshot. Because young adults and the elderly make up a proportion of the low income cohort, the data is skewed to show an inflated amount of income going to pay sales taxes. The elderly have typically made all of their major purchases and don't contribute to the sales tax base as much as younger groups. Young adults are typically making a number of major purchases that will last for many years. Their use of these purchases does not show up in later years, when their incomes have risen into middle or lower income brackets.¹⁸

Property Tax

Statewide Tax Levy. The property tax is the other tax capable of yielding sufficient revenues to make up for what would be lost with reduction or elimination of the personal income tax. But even with a statewide tax base of \$327.4 trillion, it would require a tax rate of nearly 30 mills to generate the revenue produced by the 4.25 percent tax rate on personal income. On top of the school, county, city, village, township, and other millages already in place, such a statewide millage would create levies in excess of 100 mills in some places (one mill of property tax is equal to a dollar of tax for every \$1,000 of taxable value).

Like the sales tax, the property tax is less attractive as a potential source of replacement revenue because of constitutional provisions. Specifically, the taxable value system of valuing property for purposes of taxation, combined with a long stretch of relatively low inflation, has resulted in a very low rate of growth in the statewide taxable value and, therefore, slow growth in the property tax revenues.

Taxable value was created as the property tax base when the statewide ballot Proposal A of 1994 superimposed a modified acquisition value method of determining the taxable value of property upon the existing property assessment system. For property assessments on or after December 31, 1994, annual increases in the taxable value of individual parcels of existing property are limited to the lesser of either five percent or the rate of inflation. It is worth noting that the five percent growth cap has not been employed in the 22 years of implementation of the modified acquisition value method of assessing property. The actual rate of inflation has been used every year.

When ownership of a parcel of property is transferred as defined by law, the parcel is reassessed "at the applicable proportion of current true cash value," which typically results in a one-time jump (commonly referred to as a "pop-up") in the property's taxable value. Additions and modifications to existing property and new property are placed on the tax rolls at 50 percent of current true cash value. Assessors continue to record, and the state computes, the SEV of each parcel of property for purposes of assigning a taxable value upon transfer equal to 50 percent of the true cash value.

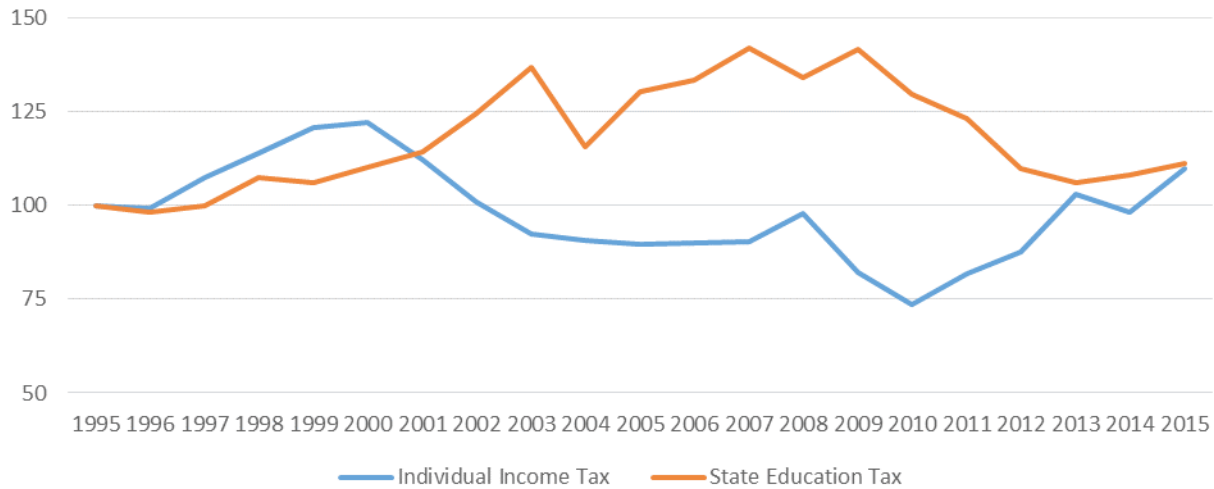
With this limitation in place, local governments and the school funding system rely on new development and transfers in the ownership of property to grow the tax base to yield new revenues.

17 Donald Phares, *Who Pays State and Local Taxes?*, Oeig-scher, Gunn, and Hain Publishers, Inc., Cambridge, 1980.

18 James M. Poterba, "Life-time Incidence and the Distributional Burden of Excise Taxes," *American Economic Review*, No. 74, May 1989.

Chart 12

Measuring the Growth of Personal Income and State Education Taxes, FY1995-FY2015



The state already levies a statewide property tax for education purposes. The State Education Tax (SET) is levied at a rate of six mills on all property across the state. It is not subject to the Headlee tax rate rollbacks because it is a state tax. As a result, the rate has remained at an even six mills since enactment of the tax act.¹⁹ **Chart 12** shows the experience of the state personal income tax and the State Education Tax (SET) since 1995, the first full year of levy for the SET. While SET tax revenue grew through the early years in Michigan's single state recession as personal income tax revenues suffered from employment declines, the property tax revenue has fallen sharply in the past eight years as the economy affected property values and the foreclosure crisis further depreciated values.

Increased Local Taxes. Locally levied property tax rates have increased in recent years as some cities and townships have struggled to deal with the loss of tax base. If fiscal pressure at the state level results in more cuts to statutory state revenue sharing, it is

likely that more local governments will seek higher rates of taxation – either through existing capacity in their property tax or through ad valorem special assessments.

Economic Impact. Property taxes generally are regarded to be somewhat regressive for two reasons. First, the tax burdens tend to impose a greater burden for low-income groups than for higher income groups due to the lack of a direct relationship between the tax bill and income. The regressive nature of the tax also affects young homeowners, purchasing their homes based on future potential income, and elderly homeowners, with home sizes and values based on past earnings. Second, the relative property wealth of individual communities can lead to greater vertical inequities. Property rich communities can levy a low tax rate on a large tax base. Communities that are not property rich must levy higher tax rates to yield equal or smaller revenue amounts, thus placing an even higher tax burden on the lower income groups that commonly reside in property poor communities.

While personal income tax reduction or elimination would benefit individuals and small businesses paying through the income tax, increased property taxes would affect these same interests.

Both the state and federal governments have programs in place to offset some of the regressive nature of prop-

¹⁹ In the midst of Michigan's single state recession, state policymakers identified a budget gimmick involving the State Education Tax. Many taxing entities were splitting the 6 mill tax across the summer and winter tax bills. Public Act 243 of 2002 required that the tax be collected in the summer levy for 2003 and subsequent years. For 2003 only, the tax rate was reduced from 6 mills to 5 mills. The net effect was to boost FY2003 tax revenues by \$455 million at the expense of FY2004 revenues.

erty taxes. The state homestead property tax credit ("circuit breaker") provides tax relief to most taxpayers equal to 60 percent of the taxes paid in excess of 3.5 percent of their household income. Senior citizens, paraplegic, hemiplegic, quadriplegic, or totally and permanently disabled or deaf individuals receive relief equal to 100 percent of the taxes paid in excess of 0 to 3.5 percent of household income, varying with size of household income. Taxpayers gain further relief when preparing federal income tax returns. Federal law permits property taxes to be deducted from adjusted gross income, thus reducing the federal income tax burden.

Elimination of the income tax would take the homestead property tax credit with it. While low income residents might enjoy some benefits of income tax relief, the regressive nature of property taxes would be more clearly felt among these same people.

The Impact of Spending Cuts

State spending differs from that of other governmental units (e.g. school districts, municipal governments) in that less than 20 percent of annual expenditures finance programs that the state directly operates and only approximately 11 percent of the total budget each year supports the compensation of state employees (this is a much lower percentage than in any other governmental sector in Michigan). The rest of the state budget (about 80 percent) supports programs operated by non-state government organizations including local public schools; community colleges and state universities; cities, villages, townships and counties; and for-profit and non-profit organizations providing services to clients of state programs (e.g., hospitals and community mental health boards). Given these realities of the state budget, substantial cuts to state spending effectively means reducing the budgets of other organizations.

General Fund Spending

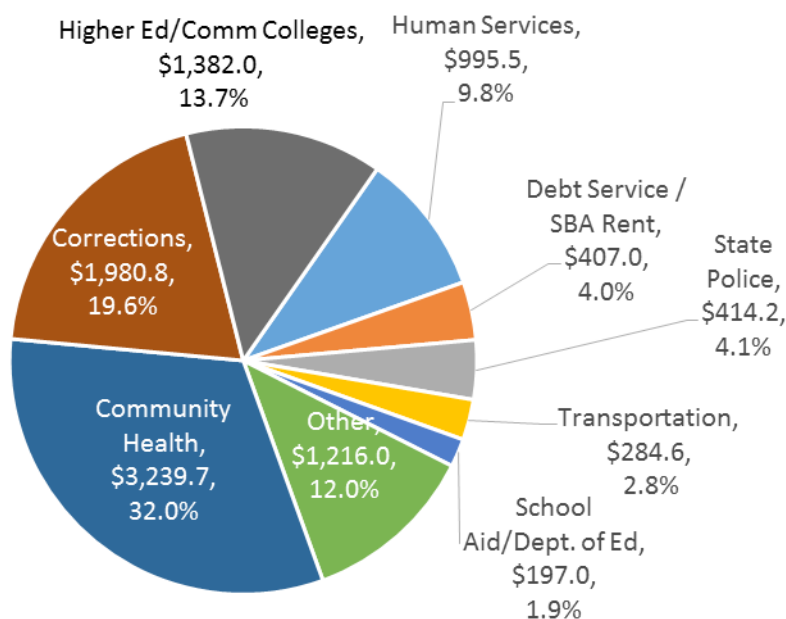
As seen in **Chart 13**, the GF/GP budget funds community health

and Medicaid services, corrections, community colleges and universities, human services, state police, and such governmental functions as the governor's office, the legislature, the attorney general's office, treasury, management and budget, and other parts of the administration of state government.

Some of the state resource committed to the GF/GP budget are used to draw down funding from federal programs. These programs require the state and/or local governments to contribute to the funding of the program. As a result, a reduction in resources committed to the GF/GP budget can have the effect of reducing spending by a greater amount.

As seen in **Chart 14**, inflation-adjusted GF/GP resources are down about 30 percent from what they were in FY2000. They are not expected to grow in the next few years. Unseen in the chart is the fact that the budget makers endeavored to avoid cutting the corrections and community health budgets throughout this period of adjustment. This means that other GF/GP programs have absorbed most of the reductions in resources. What's more, a number of recently enacted tax credits, funding obligations, and tax law changes

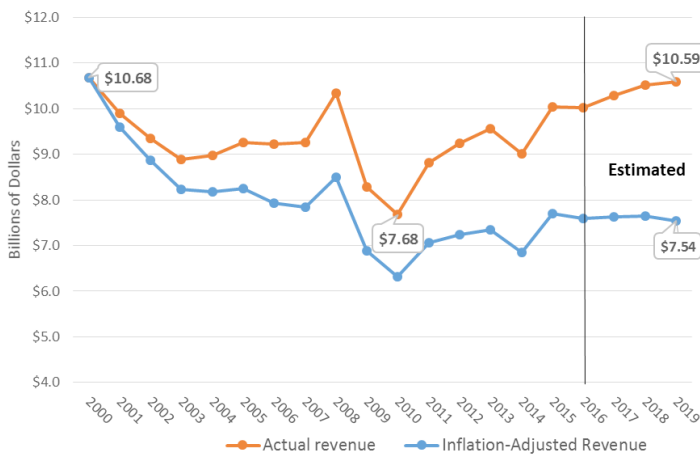
Chart 13
FY2014-15 GF/GP Appropriations
(millions of dollars)



Source: House Fiscal Agency.

Chart 14

Michigan Historic and Projected General Fund/General Purpose Resources, FY2000-FY2019



will put pressure on the budget to maintain spending levels at present levels.

Pending Budget Pressures

When considering a reduction in resources committed to the GF/GP budget, it is necessary to recognize the existing commitment of state resources that either earmark available resources to specific spending programs or have the effect of reducing the amount of available resources. These include the future redemption of business tax credits that will diminish tax revenues, the commitment of GF/GP resources for highway funding, tax credits for low and moderate income households that will diminish tax revenues, personal property tax reimbursement to local governments that commits resources away from the GF/GP budget, changes in funding obligations for the Healthy Michigan plan that will draw upon GF/GP resources, changes to the use tax related to taxation of the Medicaid managed care organization that will diminish GF/GP resources, changes to the sales tax related to the sale of automobiles and watercraft, other sales tax changes that will diminish state resources, and the pending cost of funding indigent defense in criminal cases.

Business Tax Credits. Much of the state's economic development tools prior to 2012 involved the offer of refundable tax credits against the Single Business Tax (SBT) and then the Michigan Business Tax (MBT). In 2012, the MBT was repealed and replaced with the

Corporate Income Tax (CIT), thus ending the tax credits. However, businesses that had received tax credits against the SBT or MBT were exempted from the new CIT and continued to file taxes under the MBT. Those businesses may redeem the tax credits at their discretion.

It is expected that GF/GP revenue will be reduced by about \$750 million in FY2017, and by about \$650 million in FY2018.

State policymakers continued to tinker with the MBT, even after the shift to the CIT.²⁰ The effect of these alterations is expected to reduce GF/GP revenues until all MBT liabilities have been paid off to the tune of \$5.6 million each year.

Highway Funding. The highway funding enacted at the end of 2015 earmarks a portion of personal income tax revenue currently allocated as GF/GP revenue to the Michigan Transportation Fund for distribution to the State Trunkline Fund and to local road agencies. The earmarking starts at \$150 million for FY2019, grows to \$325 million for FY2020, and increases to \$600 million for FY2021 and thereafter.

Tax Credits for Low and Moderate Income Households. The highway funding package enacted at the end of 2015 also included changes to the Earned Income Tax Credit and the Homestead Property Tax Credit. Each credit had experienced reductions with amendments to the state Income Tax Act in 2011.

The 2015 change expands the state's Earned Income Tax Credit (EITC) against the personal income tax. To qualify, a household must have earned income below certain thresholds. For tax year 2015, those thresholds range from \$52,427 for a married couple filing jointly and having three or more qualifying children down to \$14,590 for a single taxpayer with no children. The current state EITC is pegged to the federal Earned Income Tax Credit. Before the change, Michigan filers could claim a state income tax credit equal to 6 percent of any federal EITC they can claim. The change expanded the state credit to 20 percent of the federal EITC.

The change also expands the state's Homestead

²⁰ Public Act 282 of 2014.

Property Tax Credit for very low-income senior citizens and disabled taxpayers. The legislation increases the maximum amount of the homestead property tax credit from \$1,200 to \$1,500 and expands eligibility to households with higher levels of income than are currently eligible beginning with the 2018 tax year, and requires the maximum credit to be adjusted annually by inflation beginning in 2021.²¹

It is projected that these credits will reduce annual state GF/GP revenues by an estimated \$200 million per year. Complete elimination of the state personal income tax would also eliminate these tax credits, but actions to simply reduce the income tax rate would have no direct impact on the tax credits.

Personal Property Tax Reimbursement. After many years of trying, businesses were provided personal property tax (PPT) relief with the enactment of a series of bills that will phase out the PPT over a number of years. Business taxpayers with a combined true cash value of less than \$80,000 in commercial and industrial personal property will be exempt from the tax beginning in 2014, while businesses with personal property valued in excess of that threshold will see their tax on certain "manufacturing personal property" tied to industrial processing phased out between 2016 and 2023. Success of the package hinged on providing a mechanism to address an issue that had been a perennial stumbling block in past efforts at PPT reform: How do you replace the over half-billion dollars in local revenue that the PPT currently provides to local units of government?

The mechanism to replace local revenues, as amended by a package of bills enacted in April of 2014, addresses the issue in two ways. First, a portion of state use tax revenues will be redirected to a newly created special authority for distribution to local units of government. Second, a new state essential services assessment will be levied on ownership, lease, or possession of certain eligible industrial and/or commercial personal property to lessen the financial impact of these changes on the state budget.

The division of the use tax into a state and local portion will result in less revenue for the state. In FY2017, this

will amount to \$349.5 million. In FY2018, it grows to \$373.7 million. It continues to escalate until FY2028 and thereafter, when the state will be working with more than \$500 million less resources from the use tax.²²

Healthy Michigan Plan. The federal Affordable Care Act (ACA) was enacted in 2010 with the goal of expanding the availability of affordable health care coverage and reducing the number of Americans who remained uninsured. A key component of the act was allowing states to expand their Medicaid programs to provide health coverage for adults with incomes up to 138 percent of the federal poverty level. After months of debate and political wrangling, the Michigan Legislature enacted legislation in 2013 to authorize this expansion of health coverage under Michigan's Medicaid program to eligible low-income adults.

From a state budget perspective, the expansion creates upfront savings for the state. Through calendar year 2016, the federal government covers 100 percent of the coverage-related costs for the newly eligible adult population. At the same time, the state achieves savings as adults who received care under state-funded programs (e.g. behavioral health services, prisoner health care) are shifted to federally-funded Medicaid coverage. Current state savings from the expansion are estimated to be just over \$250 million.

However, under the ACA, states will begin to share in the Medicaid expansion costs starting in calendar year 2017. Beginning January 1, 2017, Michigan will have to cover 5 percent of the coverage-related costs of the expansion. That state share will increase to 6 percent in 2018, 7 percent in 2019, and finally 10 percent in 2020 and thereafter. With total Medicaid expansion costs topping \$4.0 billion in the FY2016 budget, it is projected that the future state match requirements will add \$160 million to state GF/GP costs in FY2017, with costs growing to \$250 million in FY2018 and \$310 million in FY2019 as the match requirements escalate and overall costs continue to grow.

Use Tax on Medicaid Managed Care Organizations. As part of the state's financing strategy to cover its share

21 Public Act 179 of 2015.

22 *Statewide Ballot Issues: Proposal 2014-1: Voter Approval of a New Statewide Local Tax to Reimburse Local Governments for Personal Property Tax Reforms*, Citizens Research Council of Michigan Memorandum 1128, July 2014, http://crcmich.org/personal_property_tax_reform_question-2014.

of Medicaid costs, the state statutorily earmarked revenue from two tax sources to the Medicaid program. First, Michigan includes medical services provided through Medicaid managed care organization in the base of the state's six percent use tax. The inclusion of the services in the tax base was reinstated in 2014 after being suspended in 2012. This component of the use tax generated an estimated \$375 million in GF/GP revenue in FY2015 and \$407 million in FY2016 to support the Medicaid program. However, the imposition of this tax also generates some offsetting costs. Federal regulations require that Medicaid managed care organizations receive "actuarially-sound" reimbursement rates from state Medicaid programs. That essentially means that legitimate cost increases must be met with increased reimbursement to cover those costs, and the use tax is an added expense for these entities. Thus, to provide actuarially-sound rates, Michigan had to appropriate an additional \$150 million in GF/GP support, which – when combined with matching federal dollars – allows the Medicaid managed care organizations to recover the added cost of the tax.

The second tax utilized in Medicaid financing is the Health Insurance Claims Assessment (HICA). When the use tax on Medicaid managed care organizations was initially suspended in 2012, the HICA was established as a replacement tax and imposed at a one percent tax rate on paid claims in this state on behalf of Michigan residents by health insurers in general. When revenues from HICA fell below projections, the use tax on Medicaid managed care organizations was reinstated to help cover the revenue shortfall, and the HICA tax rate was lowered to 0.75 percent.

This current two-pronged approach, however, has ended. The federal government has begun to strictly enforce regulations that essentially prohibit financing mechanisms such as Michigan's use tax on Medicaid managed care organizations. Those regulations effectively require that these taxes be broad-based – covering all health care providers within a given category, not just those that serve Medicaid patients.

As a result, Michigan has once again eliminated its use tax on Medicaid-only managed care organizations. The tax was in place for only the first quarter of FY2017. This will reduce revenue from this component of the use tax by \$305 million from FY2016 to FY2017. By

FY2018 and each year thereafter, the state will lose the entire \$407 million in revenue.

Sales Tax on the Difference. Prior to 2014, Michigan was one of a small number of states that charged its sales tax on the full purchase price of a new motor vehicle, without regard to the value of any trade-in vehicle. In most states, the sales tax is assessed only against the difference between the purchase price and the agreed-on value of the trade-in vehicle, a practice commonly referred to as "sales tax on the difference".

Beginning on December 15, 2013, Michigan joined the majority of other states in adopting this special treatment for trade-in vehicles.²³ However, the trade-in exemption will be phased in over a number of years. The change exempts the first \$2,000 of the agreed-upon value of any trade-in motor vehicle or recreational vehicle from the sales tax when the trade-in value is applied toward the purchase of a new or used vehicle. This \$2,000 limit is then raised by \$500 annually on January 1st of each year and would reach \$14,000 on January 1, 2038. Barring further legislative changes, the limit would then be eliminated on January 1, 2039, at which time the full value of any trade-in vehicle would become exempt. A similar exemption for the agreed-upon value of a watercraft trade-in is implemented immediately and in full without the phase-in period.

This change is projected to reduce revenue by \$49 million in FY2017, \$57 million in FY2018, and an increasing amount each year thereafter. When fully phased-in in 2039, it is expected that sales tax revenue will be about \$134 million less than it would have been had this change not been enacted.²⁴

Other Sales Tax Changes. In 2015, the sales and use taxes were amended to provide new tax exemptions for data center equipment sold to or used by a qualified data center or co-located business. This economic development related exemption is projected to reduce sales tax revenue by \$6 million in FY2017 and by about \$6.5 million thereafter.

²³ Public Act 160 of 2013.

²⁴ House Fiscal Agency, www.legislature.mi.gov/documents/2013-2014/billanalysis/Senate/pdf/2013-SFA-0089-N.pdf.

Another amendment to the Sales Tax Act in 2015 earmarks an amount of sales tax revenue equal to the collection of sales tax imposed at a rate of 2 percent attributable to retail sales of aviation fuel for distribution to certain aeronautics programs.²⁵ This change is expected to reduce GF/GP revenue by \$13.5 million in FY2017 and thereafter, with the revenue redirected to the benefit of the State Aeronautics Fund and Qualified Airport Fund.

Indigent Defense. Although federal law and the state Michigan Constitution established that every person accused of a crime has the right to counsel, Michigan was one of many states for which indigent defense was perceived to be lacking. The lack of attention to this issue and chronic underfunding left those without adequate representation serving longer sentences than otherwise might be the case, increased indigent appeals cases, and left the wrongly convicted incar-

cerated.

Public Acts 93 and 94 of 2013 established the Michigan Indigent Defense Commission Act to provide indigent criminal defense services independent of the judiciary and revised provisions in the Code of Criminal Procedure to provide for the appointment of counsel conformance with provisions of the Michigan Indigent Defense Commission Act.

Although the court system is a state function, district and circuit courts in Michigan are primarily funded by local governments. Faced with provisions of the Headlee Amendment meant to protect against the state pushing the cost of fulfilling its responsibilities down to local governments, the new indigent defense system will include a system of directing state funds to the counties and cities that are primary funders of the courts. The cost of this obligation is unknown at this time.²⁶

25 Public Act 262 and 263 of 2015.

26 House Fiscal Agency, www.legislature.mi.gov/documents/2013-2014/billanalysis/House/pdf/2013-HLA-4529-4569088C.pdf.

Conclusion

Michigan's love-hate relationship with the personal income tax appears to be entering a new chapter. Legislative attention on the tax imagines ways to reduce the tax rate or eliminate the tax altogether. Such an exercise will not come easy and would have implications for the efficacy of government services: not just the state government but also counties, cit-

ies, villages, townships, school districts, community colleges, universities, and many public and private providers of government services that rely on state appropriations. Changes stand to affect the ability of those governments to provide public goods and services, thus affecting the quality of life for residents and businesses in Michigan.

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