House Legislative Analysis Section
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GOVERNOR'S TAX CUT PROPOSAL

House Bill 4228 (with committee amendment)
Sponsor: Rep. James Ryan

House Bill 4229 (with committee amendment)
Sponsor: Rep. David Galloway

House Bill 4230 (with committee amendment)
Sponsor: Rep. Susan Grimes Munsell

House Bill 4231 as introduced
Sponsor: Rep. Alvin H. Kukuk

House Bill 4232 as introduced
Sponsor: Rep. Sandra Hill

House Bill 4233 as introduced
Sponsor: Rep. Charles Perricone

House Bill 4234 (with committee amendment)
Sponsor: Rep. Eric Bush

First Analysis (2-7-95)
Committee: Tax Policy

THE APPARENT PROBLEM:

Budget specialists point out that the healthy condition of the state's economy has significantly improved the outlook for state tax revenues. In fact, the most recent consensus revenue estimate for fiscal year 1994-95, arrived at by legislative and administration budget experts at a January 12th conference, predicts revenues this year will exceed the constitutional revenue limit by $297.3 million. (This is also a result of the state assuming a much larger portion of the funding for public schools in the state under the new school financing system that began with the 1994-95 school year.) The state constitution contains a limit on "the total amount of taxes which may be imposed by the legislature in any fiscal year on the taxpayers of this state." The limit was placed in the constitution by voters in 1978 as one element of the so-called Headlee Amendment, and restricts state revenue to a proportion of total personal income in the state. Revenue cannot exceed 9.49 percent of the previous calendar year's total personal income or of the average of the previous three years, whichever limit is higher. The constitution says if revenues exceed the limit by one percent or more, excess revenues must be refunded pro rate based on personal income tax and single business tax liability. If the limit is exceeded by less than that, the excess can be transferred to the State Budget Stabilization (or "rainy day") Fund. One way to address the "problem" of excess state revenues is to return money to taxpayers through reduced taxes before the end of the fiscal year. Governor Engler has developed a proposal to do that; it would return $186 million to taxpayers and deposit the remainder of excess revenue in the BSF.

THE CONTENT OF THE BILLS:

The package of bills would, in general, do the following:

* Eliminate payments for unemployment compensation, worker's compensation, and federal insurance contributions from the base of the single business tax.

* Increase the value of the personal exemption in the income tax from $2,100 to $2,400 for 1995 and 1996, and to $2,500 in 1997, and index it to inflation thereafter.

* Raise the limit on the three separate credits that can be taken against the income tax for contributions to public institutions, community foundations, and homeless shelters/food banks from $100 to $175 for a single filer and $200 to $350 for a joint filer.

* Phase out the intangibles tax, which taxes income, such as interest and dividends, from intangible property, such as stocks, bonds, mortgages, and cash, and eliminate the tax completely as of January 1, 1998.

A description of the bills in the package follows.

<u>Single Business Tax.</u> Three bills would amend the Single Business Tax Act (MCL 208.4 et al.) to remove from the tax base, for tax years beginning after December 31, 1994, payments for unemployment compensation, workers compensation, and federal insurance contributions (FICA).

<u>House Bill 4228</u> would apply to payments to state and federal unemployment compensation funds.

<u>House Bill 4229</u> would apply to payments, including self-insurance payments, for worker's compensation insurance and insurance under the Federal Employers Liability Act.

<u>House Bill 4230</u> would apply to payments under the Federal Insurance Contribution Act, the Railroad Retirement Tax Act, and similar social insurance programs.

In each case, the bill would specify that a certain kind of payment would not be included in the compensation that must be added back to the tax base used for federal tax computations. The SBT tax base, before reductions, is typically described as a company's compensation paid (or labor costs), profits, interest paid, and depreciation.

Further, House Bill 4228 contains a "hold harmless" provision described by tax specialists as protecting local units from a loss of SBT revenue sharing. (In July 1996, revenue sharing payments would be increased by 0.7 percent and, beginning in 1997, by 1.19 percent of the gross collections before refunds of the SBT for the 12-month period ending on the June 30 immediately preceding the payment date.)

<u>Income Tax\Personal Exemption.</u> Two bills would amend the Income Tax Act (MCL 206.30) to increase the personal exemption and index it to inflation. Under the act, taxpayers are permitted to deduct $2,100 from taxable income for each personal exemption claimed.

<u>House Bill 4234</u> would increase the personal exemption to $2,400 for tax years 1995 and 1996 and to $2,500 for tax years beginning after 1996.

Under <u>House Bill 4232</u>, for tax years after 1997, the personal exemption would be adjusted based on the change from one year to the next in the U.S. consumer price index. The exemption would be adjusted in $100 increments.

The bill specifies that the exemption would be adjusted by multiplying the personal exemption for the tax year beginning in 1997 by a fraction, the numerator of which would be the U.S. consumer price index for the state fiscal year ending in the tax year for which the adjustment was being made and the denominator of which would be the consumer price index for the 1996-97 state fiscal year. The product would be rounded to the nearest $100 increment.

Also, House Bill 4234 contains "hold harmless" language adjusting the calculations regarding the percentage of collections to be deposited in the State School Aid Fund and the percentage to be distributed to cities, villages, townships, and counties in revenue sharing monies.

Income Tax\Contribution Credit. Under the Income Tax Act, taxpayers can claim a credit, up to certain limits, for 50 percent of contributions to 1) certain designated institutions (e.g., public broadcasting stations, public libraries, and colleges and universities); 2) community foundations; and 3) food banks and homeless shelters. Currently, in each case, the credit cannot exceed $100 for an individual taxpayer or $200 for a husband and wife filing jointly. House Bill 4231 would increase the limit to $150 for an individual and $300 for a joint filing for each of the three credits, beginning with the 1995 tax year.

Intangibles Tax. The bill would phase out the state's intangibles tax, which is a tax, generally speaking, on the income (e.g., dividends and interest) derived from intangible property (e.g., stocks, bonds, notes, and money). The act imposes a tax of 3.5 percent on income from income-producing intangible personal property; a tax of one-half of one percent of face or par value for intangible property not producing income; and a tax of 20 cents per $1,000 of deposits, levied against banks and savings and loans.

House Bill 4233 would amend the intangibles tax act (MCL 205.133) in the following ways.

-- The act allows taxpayers a credit of $175 for single taxpayers and $350 for married couples filing jointly. This means there is no tax liability until income from intangible property exceeds $5,000 for single filers or $10,000 for joint filers. (The exemption does not apply to financial institutions.) The bill would increase the credit to $280 for single taxpayers and $560 for joint filers beginning in calendar year 1994 or a fiscal year ending after 1993. This would raise the threshold for owing tax to $8,000 and $10,000, respectively. (The amounts referred to here as credits are described in the act as deductions that can be made in computing the tax.)

-- A taxpayer's tax liability under the act would be reduced by 25 percent for calendar year 1994 (or a fiscal year ending in 1994) and 1995; by 50 percent for 1996; and by 75 percent after 1996.

-- The act would be repealed effective January 1, 1998.

FISCAL IMPLICATIONS:

The House Fiscal Agency has prepared the following chart showing the estimated revenue impact of the proposed tax cuts in Governor Engler's proposal, based on the administration's revenue assumptions. The chart shows the savings to taxpayers and loss of revenue to the state in millions of dollars. (1-30-95)

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	5-yr total
Income tax	$69	$97	$119	$147	$176	$608
Single Business	74	105	112	117	123	531
Intangibles Tax	43	45	79	115	155	437
Total	$186	$247	$310	$380	$454	$1,576

It should be noted that the governor's proposal would return, as shown above, $186 million of the $297.3 in excess revenue to taxpayers, while the remainder (over $111 million) would be deposited in the budget stabilization fund. Also, as reported from the House Tax Policy Committee, the single business tax and income tax bills contain "hold harmless" provisions to protect revenue sharing distributions to local units from collections under those taxes. (The "hold harmless" provisions were not part of the governor's proposal.)

ARGUMENTS:

For:

The governor's proposal is a balanced way to return to the state's taxpayers the excess state revenues that would otherwise be collected in fiscal year 1994-95. Without legislation, the constitution would require taxes to be refunded to those paying the income tax and single business tax on a pro rate basis. This would likely be an administrative headache, and the refund then would just be a one-time benefit. It is better to provide permanent tax cuts, says the Engler administration, to add to the 11 previous tax cuts provided taxpayers in recent years.

This tax cut proposal provides over $1.5 billion in tax relief over five years. It is balanced because it provides relief both to individuals, through an increase in the personal exemption, and to businesses, through an adjustment in the tax base of the single business tax. It also helps savers and investors, through the gradual elimination of the intangibles tax, an unfair, outmoded tax.

The income tax bills raise the personal exemption immediately by $300, with a further $100 increase the next year and annual increases of $100 expected thereafter with the indexing of the exemption to inflation. This approach benefits all income tax filers, and particularly benefits taxpayers with families. There is also an increase in the credit available for making certain kinds of contributions, which should help such diverse organizations as public television, colleges and universities, museums and libraries, community foundations, homeless shelters, and food banks. The single business tax bills eliminate from the tax base the cost to employers of worker's compensation, unemployment compensation, and federal taxes, such as social security. This essentially will eliminate imposing the single business tax on top of other taxes. Further, companies often have little or no control over these costs, so taking them out of the tax base will give companies greater control over their tax burden. And, this aspect of the proposal has the beneficial effect of reducing the cost to employers of adding workers, which is good for job creation, a key element in a healthy state economy.

The intangibles tax is a form of double taxation. It was made a state tax in 1939, tax specialists say, as a counterpart to the personal property tax (which is on tangible personal property). That was long before the enactment of an income tax. With the arrival of the state income tax in 1967, the interest and dividend income earned from intangible property, such as stocks, bonds, mortgages, land contracts, and savings accounts became subject to two state taxes. This is clearly unfair. And the fact that a sizeable portion of the revenue from the intangibles tax is contributed by very wealthy individuals and banks (and other depository institutions) does not make it any less unfair. Not all intangible taxpayers are wealthy. Some of those who pay the intangibles tax are people who have accumulated large amounts of savings during a lifetime of work to cover their retirement. They may have no pensions or very small pensions. Why should they be taxed on their retirement income, when those collecting pensions and social security are not? Repeal of the intangibles tax is long overdue. Further, when combined with the significant reduction in death taxes enacted in 1993, the intangibles tax proposal sends the message that Michigan does not want upper income taxpayers to flee to states with less onerous tax systems but wants capital put to work here sponsoring entrepreneurs and building the economy.

Against:

Any permanent tax cuts ought to help those who need it the most, the middle-class taxpayers with families. The tax refund should be directed to average taxpayers, struggling to meet their obligations, such as child care and college tuition, with stagnant incomes. It should not be directed to the wealthiest individuals in the state and financial institutions (through repeal of the intangibles tax) or to big business (through the SBT base reduction). What does this proposal offer the average taxpayer? Barely more than $50 per year for a family of four! Meanwhile, the average annual intangibles tax cut for the more than 1,400 taxpayers with $1 million or more in income will be over $17,000 once the act is repealed. Opponents of the intangibles tax cut say that 97 percent of the state's taxpayers do not pay the tax; they will receive no benefit from this tax cut, which will total $434 million over five years. Of the estimated $105 million in single business tax relief envisioned in fiscal year 1996, some $42 million will go to just 110 firms, say opponents of the proposal. Many businesses don't pay the SBT or use an alternative method of computing tax. They will not benefit from this proposal. Overall, this is not an equitable plan; it is too narrowly targeted.

Last year, the legislature enacted significant cuts in the single business tax and reduced taxes on private pensions and retirement income. That was the way excess state revenues were returned to taxpayers the first time. Now it is time to cut taxes significantly for the average taxpayer, through income tax cuts that benefit everyone. One alternative proposal, put forward by House Democrats, calls for a larger immediate increase in the personal exemption (up $500 to $2,600), a deduction for college tuition up to $5,000 per student, and deduction for child care costs up to $5,000 per child. According to one estimate, this would provide annual tax relief of $528 to a family with two children in college or day care rather than $53, as under the governor's plan. This would be meaningful tax relief for Michigan families; it would be a meaningful "family friendly" tax policy. (Other alternatives proposed, with similar impact, would increase the personal exemption even more, and add an additional exemption for families with very young children.)

Against:

Some people would argue that making permanent tax cuts is not the right approach. The constitution requires excess revenue to be returned to taxpayers, but that could be done through refunds or one-time tax changes that do not affect the tax base. What happens in future years when state revenues are no longer so robust? When there is a downturn in the economy, which is inevitable, where will the state find the revenues it needs to meet its obligations?

Response:

The other side of the coin is restraining spending. Sometimes it is the difficult economic times that force the hard choices about budget priorities.

POSITIONS:

Governor Engler and State Treasurer Roberts testified in support of this package before the House Tax Policy Committee. (1-24-95 and 1-26-95)

Among those indicating support for the package to the House Tax Policy Committee (without testifying) were the Michigan Manufacturers Association; the Michigan State Chamber of Commerce; the National Federation of Independent Business; the Small Business Association of Michigan; and the Michigan Association of Home Builders. (2-2-95)

A representative of the Michigan State AFL-CIO testified before the House Tax Policy Committee in support of alternative proposals. (2-2-95)