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INCOME TAX RATE REDUCTION

House Bill 5978 with committee amendment

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House Bill 5978 (9-15-98)

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Sponsor: Rep. Mark Schauer

Committee: Tax Policy

THE APPARENT PROBLEM:

The current political conversation about state taxes includes such questions as whether or not the income tax should be reduced; if so, when (now or later, all at once or gradually); if so, how to distribute a reduction (generally across all taxpayers or targeted to special categories of taxpayers); if a general reduction, by what means (a rate reduction, an increase in the personal exemption, or some combination of the two); and, how large a reduction. Also part of the debate is whether and how to protect the funding of services that depend on a specified portion of income tax revenues, such as spending on public schools and revenue sharing for local governments. If such spending is to be protected, should it be done by statute or through constitutional guarantees?

Governor Engler recently announced a tax cut proposal that would reduce the income tax rate from 4.4 percent to 3.9 percent in even increments, beginning in the 2000 tax year and extending through the 2004 tax year. (The proposal is embodied in Senate Bills 1079-1083.) House Speaker Hertel has recommended that alternatives to this plan be explored, including the possibility of increasing the personal exemption (the standard amount deducted from taxable income for the taxpayer and each dependent) from $2,800 to $5,000, on the grounds that raising the personal exemption would be more beneficial to families earning $75,000 or less. Other proposals would combine the two approaches.

THE CONTENT OF THE BILL:

The bill would amend the Income Tax Act (MCL 206.51) to reduce the rate from 4.4 percent to 4.3 percent in 1999; 4.2 percent in 2000; 4.1 percent in 2001; 4.0 percent in 2002; 3.9 percent in 2003; and 3.8 percent on and after January 1, 2004.

Tie-Bars. The bill is tie-barred to House Joint Resolution BB and to House Bills 4374 and 4985. HJR BB would establish a baseline amount of revenue for local and intermediate school districts and for revenue sharing for local units of government and require that funding for these purposes increases in the same proportion as total state revenues increase. (See HLAS analysis dated 4-30-98.) House Bills 4374 and 4985 would amend the Income Tax Act to raise the personal exemption. (See HLAS analysis dated 6-18-98.)

As reported from the House Tax Policy Committee, House Bills 4374 and 4985 would amend the Income Tax Act to raise the personal exemption in the following way. Currently, the personal exemption is $2,500 adjusted annually for inflation (rounded to nearest $100 increment), plus $200. [For the 1998 tax year, the personal exemption is $2,800.] House Bill 4985 would make the starting figure in those calculations $2,900 (rather than $2,500) for the 2000 tax year and $3,200 for the 2001 tax year. House Bill 4374 would make the starting figure $3,500 for the 2002 tax year, $3,800 for the 2003 tax year, and $4,100 for the 2004 tax year and subsequent tax years.

[Note: The actual personal exemption in any year would depend on the amount added due to inflation under Section 206.30(7). For example, if $100 were added each year due to the inflation calculation, in combination with the amounts added by these two bills, the personal exemption for tax year 2004 would be $5,000.]

HJR BB would be submitted to the state's voters at the next general election and, as reported from the House Tax Policy Committee, proposes amending the state constitution (Article IX, Sections 11 and 40) in the following ways:

** It would guarantee that the total amount distributed by law to assist counties, cities, villages, and townships will change from one state fiscal year to the next by at least the same percentage as the change in the combined gross state school aid fund revenue and gross general fund/general purpose revenue (as adjusted for changes in state law or administrative determinations). The requirement would apply beginning with the 1999-2000 state fiscal year. (The distributions referred to are in addition to those provided for in Article IX, Section 10, which requires that 15 percent of the first 4 cents of the sales tax be used for assistance to townships, cities, and villages on a population basis.) For the purpose of determining distributions under the new section and Section 10, the calculation would be made using $1.486 billion as the total distribution amount for the 1998-99 state fiscal year.

** It would guarantee that the total amount appropriated for state aid to local and intermediate school districts will change from one state fiscal year to the next by at least the same percentage as the change in the combined gross state school aid fund revenue and gross general fund/general purpose revenue (as adjusted for changes in state law or administrative determinations). Distributions for the 1999-2000 state fiscal year would be calculated using $10 billion as the total distribution amount for the 1998-99 state fiscal year.

** It would guarantee that each local and intermediate school district's total state and local per pupil revenue for school operating purposes in each state fiscal year be no less than its per pupil revenue for the 1997-98 state fiscal year (as adjusted for consolidations, annexations, or other boundary changes). This would begin with the 1999-2000 state fiscal year.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, House Bill 5978 would result in a revenue reduction of $123.7 million in fiscal year 1999; $303.1 million in fiscal year 2000; $500.2 million in fiscal year 2001; $716.2 million in fiscal year 2002; $952.5 million in fiscal year 2003; $1,210.8 million in fiscal year 2004; and $1,326.7 million in fiscal year 2005. (HFA fiscal note dated 7-1-98) House Bills 4374 and 4985, as reported from the House Tax Policy Committee, would reduce income tax revenues in 2005, when fully phased in, by $480 million, according to information from the House Fiscal Agency. (See HLAS analysis dated 6-18-98)

ARGUMENTS:

For:

The bill would reduce the income tax rate from 4.4 percent to 3.8 percent over six years, beginning in January of 1999. This will produce a $1.3 billion annual tax cut and a $5 billion cumulative tax cut by the year 2005. The tax cut proposed in this bill starts one year earlier and goes deeper than that proposed by Governor Engler. Thus, it is a more generous tax cut. The bill is also tie-barred to two bills that would increase the personal exemption. This provides a balanced approach, tying together a rate reduction and an increase in the personal exemption. Tax specialists typically say that reducing income taxes by cutting the rate tends to provide more relief as income rises, while reducing taxes by raising the personal exemption tends to be proportionally more beneficial to lower and moderate income taxpayers with families. Moreover, the bill is tie-barred to a proposed constitutional amendment safeguarding spending on public elementary and secondary schools and revenue sharing to local units of government, protecting them from cuts that otherwise would result from income tax reductions.

Response:

The governor's proposal, a rate reduction from 4.4 percent to 3.9 percent over five years and starting in the year 2000, is more reasonable and responsible. It delays the implementation of any additional tax cuts until the state budget has absorbed recently enacted tax cuts whose impact has yet to be felt. (It should be noted that the personal exemption has only recently been increased and indexed for inflation.)

For:

Tying this bill to House Joint Resolution BB would guarantee that public elementary and secondary schools and revenue sharing payments to local units of government would be held harmless from cuts in income tax revenue. It keeps the promises made in the past by state policymakers to school districts, cities, townships, and counties by constitutionally establishing a revenue baseline and then guaranteeing that revenue for these programs will grow at least equally with total state revenues. If tax cuts force spending cuts, other areas of the budget will be affected; the promises made to schools and local units will be kept.

Response:

Earmarking revenue in this manner substantially reduces the flexibility needed in the future by the legislature and the governor to make fundamental budget decisions based on contemporary assessments of the state's needs. (Tying the bill to this flawed proposal also makes it less likely the proposed tax cuts will actually be enacted.) Senate Bill 1079, part of the package which contains the governor's rate cut proposal, addresses this issue by earmarking a portion of the income tax for schools, with the intent of providing the same revenue to schools that they would have received had there been no rate cut. (Currently, 23 percent of gross income tax collections before refunds goes to school aid; the bill would earmark an equivalent amount by specifying that the equivalent of a tax rate of 1.012 percent would go to school aid.)

Against:

Is it wise to be proposing tax cuts of this magnitude far into the future when the state's fiscal future remains uncertain? Significant tax cuts enacted in recent years have not yet been fully absorbed. New increases in the personal exemption are due to take effect for 1998, along with additional deductions from taxable income for young children. The exemption has been adjusted for inflation and increased by $200 on top of that. Taxpayers can also deduct $600 for each child under 7 and $300 for each child 7 through 12. Is this really the time for a large rate reduction, coupled with a substantial additional increase in the personal exemption? There is no guarantee that the economy, and the resulting state revenues, will remain so robust. This bill would result in a large reduction in state revenue year after year, as would the governor's tax cut proposal. Won't this negatively affect state (and local) government's ability to provide critical services?

POSITIONS:

There are no positions at present.

Analyst: C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.