

## INCOME TAX RATE REDUCTION

**House Bill 4033 as introduced**

**Sponsor: Rep. Larry Julian**

**House Bill 4034 as introduced**

**Sponsor: Rep. Randy Richardville**

**House Bill 4035 as introduced**

**Sponsor: Rep. Gerald VanWoerkom**

**House Bill 4036 as introduced**

**Sponsor: Rep. Jim Howell**

**House Bill 4037 as introduced**

**Sponsor: Rep. Gary Woronchak**

**House Bill 4038 as introduced**

**Sponsor: Rep. Nancy Cassis**

**Committee: Tax Policy**

**First Analysis (2-2-99)**

### ***THE APPARENT PROBLEM:***

In two successive State of the State speeches, Governor Engler has proposed reducing Michigan's individual income tax by one-half of a percent, from 4.4 percent to 3.9 percent, over five years, beginning in the year 2000. Representatives of the administration have said that its policies of reducing taxes and restricting spending have contributed to the strength of the state's economy, its improved business and job creation climate, and its low levels of unemployment, while continuing to generate the tax revenues needed to meet its responsibilities. The new rate reduction proposal, says the administration, represents a commitment to ongoing tax relief, a statement of priorities that a significant portion of future tax revenue growth will be returned to the taxpayers for families -- not state government -- to spend as they choose.

### ***THE CONTENT OF THE BILLS:***

The bills would amend the Income Tax Act to reduce the state income tax rate from 4.4 percent to 3.9 percent over a five-year period, beginning in 2000. That is, the income tax rate would be 4.3 percent in

2000 (House Bill 4034); 4.2 percent in 2001 (House Bill 4033); 4.1 percent in 2002 (House Bill 4036); 4.0 percent in 2003 (House Bill 4037); and 3.9 percent on and after January 1, 2004 (House Bill 4038).

Currently, 23 percent of gross income tax collections before refunds are required to be deposited in the State School Aid Fund. House Bill 4035 would specify instead that, beginning January 1, 2000, the percentage of gross collections before refunds dedicated to the State School Aid Fund would have to be equal to 1.012 percent divided by the income tax rate, multiplied by 100. (Note: 23 percent of 4.4 equals 1.012, so income tax revenues dedicated to the School Aid Fund would not be reduced as the tax rate decreases.)

None of the bills could take effect unless they all were enacted. House Bill 4035 is tie-barred to all of the rate-cut bills, and they are all tie-barred to House Bill 4035. In addition, House Bill 4033, 4036, 4037, and 4038 are tie-barred to each other.

MCL 206.51 et al.

## **BACKGROUND INFORMATION:**

For purposes of the state income tax, tax liability is arrived at by multiplying taxable income by the tax rate. Taxable income is derived from adjusted gross income (AGI) on the federal income tax form. This number is reduced by several deductions, notably an exemption for each person in the household (known as the personal exemption or dependency exemption). So, for example, the current personal exemption of \$2,800 reduces a household's taxable income by that amount for each person qualifying for an exemption. A family of four would reduce the amount of income subject to tax by 4 times \$2,800, or \$11,200. Additional smaller exemptions exist for seniors and certain other taxpayers and, beginning in 1998, for young children. There are also significant deductions for public and private pension benefits and for dividend and interest income of senior citizens. Once taxable income is arrived at and the tax rate applied, tax liability can be reduced by a number of available credits. Credits exist for income taxes paid to Michigan cities, for contributions to certain kinds of educational, cultural, and charitable organizations, and for fees and tuition paid to certain specified colleges and universities in the state. There is also a credit for home heating costs for persons with low incomes and a senior citizen prescription drug credit. (Exemptions or deductions reduce the amount of income subject to tax; credits directly reduce the amount of tax owed.) Also, the amount paid in state income tax can be deducted from taxable income for federal income tax purposes, if the taxpayer itemizes deductions. (For further information, consult the "Michigan Taxpayer's Guide" prepared annually by the Legislative Service Bureau.)

## **FISCAL IMPLICATIONS:**

The House Fiscal Agency reports that, under the legislation, there would be a loss of \$130 million in general fund/general purpose revenues in the 1999-2000 fiscal year. When fully phased in, the rate cuts would result in a reduction in general fund/general purpose revenues of \$1.1 billion annually. The State School Aid Fund would be held harmless. (HFA Fiscal Note dated 1-28-99) For purposes of comparison, note that general fund/general purpose revenues are expected to total about \$9 billion for the 1998-99 fiscal year. General fund/general purpose income tax revenues are expected to be about \$5 billion. About \$1.8 billion in income tax revenues is

expected to flow to the school aid fund in fiscal year 1998-99. (See the HFA booklet, "Michigan Economic Outlook and House Fiscal Agency Revenue Estimates Fiscal Years 1998-99 and 1999-2000" dated January 1999.)

## **ARGUMENTS:**

### **For:**

This proposal offers a meaningful, affordable, responsible method of reducing income taxes and letting Michigan residents keep more of the money they earn. It represents a substantial commitment to ongoing tax relief and fiscal responsibility by returning a significant portion of anticipated future revenue growth to taxpayers. It continues the regimen of tax reduction and budget discipline of recent years, a regimen that helps to explain why the state's economy has been so robust and why state revenues have been so healthy. Under this new proposal, when fully phased in, income taxes will be reduced by over \$1 billion annually. (Over the five-year period, taxpayers will see \$3 billion in tax savings.) Yet, by phasing in the tax cut over five years, and by beginning implementation in the year 2000, the proposal ensures that the state budget will be able to absorb the income tax rate reduction. Remember that several recently enacted tax cuts, including an increase in the personal exemption and additional exemptions for young children, only became effective in the 1998 tax year and are only now having an effect on state revenues.

Reducing the rate provides an equitable across-the-board tax cut. Each taxpayer is treated the same. Households with the same income get the same tax reduction. (This is not the case with tax cuts resulting from changes in the personal exemption or resulting from additional credits and deductions.) Further, advocates say, a straightforward rate reduction is attractive to business and improves the state's economic competitiveness. The income tax rate is one of the indicators businesses -- and individuals -- rely on when making location decisions. This proposal returns the tax rate to its level in 1971! (Note that then the personal exemption was \$1,200. For 1998, it is \$2,800.) Fully phased in, an individual, couple, or family with taxable income of \$30,000 per year will save \$150 annually in state income taxes; those with a taxable income of \$60,000 will save \$300; and those with a taxable income of \$90,000 will save \$450; and so on.

**For:**

Although not part of the governor's proposal, House Bill 4035 would hold the state school aid fund harmless. Currently, 23 percent of gross income tax collections before refunds goes to that fund. Under the bill, this percentage would rise as the tax rate falls to keep the earmarking at the current level. When the rate falls to 3.9 percent, the earmarked percentage would rise to nearly 26 percent.

**Response:**

The "hold harmless" provision only locks in current levels of earmarking for schools, which some would argue is inadequate. Critics of earmarking point out that it reduces the flexibility of future governors and legislatures when they are faced with making budget decisions based on contemporary assessments of the state's needs. In this case, when revenues fall, elementary and secondary education funding will be protected, but not funding on other critical programs.

**Against:**

The question needs to be asked, if the state is to return large amounts of tax revenue to taxpayers, is the income tax rate cut proposal the best way to accomplish this? House Democrats have proposed an alternative plan that would increase the personal exemption to \$6,400 over five years, which they argue would provide more tax relief to more families than the governor's proposal. Generally speaking, cutting the income tax rate provides proportionately more relief as household income rises, while increasing the personal exemption is more beneficial to lower and moderate income families. Raising the personal exemption treats everyone equally, regardless of income. The governor's plan provides more relief to the better off. House Democrats argue that their plan benefits single taxpayers earning \$35,000 or less; families of two earning \$65,000 or less; families of three earning \$100,000 or less; families of four earning \$135,000 or less; and families of five earning \$170,000 or less. A family of four, they say, will not owe state income tax until they earn over \$25,600. (House Democrats claim that their plan saves the family of four earning \$50,000 per year \$633 when fully phased in, while the governor's plan would save them \$188.) This is a fairer, more progressive tax cut plan. It provides far greater relief for those of moderate and lower incomes who have not benefitted from such things as the elimination of the intangibles tax and the reduction in inheritance taxes.

Further, some have called for a larger, more rapid tax cut, rather than one phased in over five years, perhaps by combining the rate cut with a personal exemption increase.

**Response:**

The personal exemption has been increased steadily over the past few years, from \$2,100 to \$2,400 for tax years 1995 and 1996, to \$2,500 for 1997, and to \$2,800 for 1998. The exemption has also been indexed for inflation. (Additional amounts are available to seniors and certain other taxpayers.) Further, additional exemptions of \$600 per child under 6 and \$300 per child aged 7 through 12 take effect for the first time for 1998. It should be noted that the state constitution provides for a flat rate income tax; it specifically prohibits an "income tax graduated as to rate or base." A proposal to cut the tax rate across the board is more in keeping with that philosophy. Under the governor's plan, the larger a household's tax liability, the larger its tax reduction.

**Against:**

Is it wise to legislate tax cuts taking effect three, four, or five years out? Wouldn't it be better to let other legislatures determine revenue and spending needs in those years? Will the state be able to meet its obligations and the needs of its residents if it foregoes \$1 billion in annual revenue? This is a very large reduction in revenue. There is no guarantee that the economy, and resulting state revenues, will remain so robust. Is it fair to reap the political benefits from enacting distant tax cuts while possibly leaving future political leaders with the task of dealing with fiscal crisis?

**Response:**

As noted earlier, advocates of this proposal say that it represents a statement of priorities and locks in a policy of returning a significant portion of revenue growth to the taxpayers. It represents a commitment to ongoing tax relief. There is always a tension in budgeting between determining the amount of revenue available and budgeting accordingly and determining spending needs and then raising revenue. This tension will continue.

**POSITIONS:**

The state treasurer testified in support of the bill on behalf of the Engler Administration. (1-27-99)

A representative of the Michigan Chamber of Commerce has indicated support for the proposal. (1-27-99)

The Michigan Education Association supports the proposal with its provision to "hold harmless" the state school aid fund. (2-2-99)

Analyst: C. Couch

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■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.