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SFA BILL ANALYSIS

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Senate Bill 1 (Substitute S-1 as reported by the Committee of the Whole)
Senate Bills 2 through 5 (as reported without amendment)
Sponsor: Senator Mike Goschka (S.B. 1)
Senator Bev Hammerstrom (S.B. 2)
Senator Loren Bennett (S.B. 3)
Senator Dale L. Shugars (S.B. 4)
Senator Bill Bullard, Jr. (S.B. 5)
Committee: Finance

Date Completed: 2-2-99

RATIONALE

In recent years the State's tax structure has undergone fundamental change, with many taxes being reduced and some increased. Since fiscal year (FY) 1991-92 these tax increases and tax decreases will have resulted in a net tax reduction of approximately $11.7 billion through FY 1998-99. In his 1998 State of the State address the Governor, citing the strength of the Michigan economy, an unemployment rate below the national average for four consecutive years, an improved bond rating, and the net tax cut, recommended that taxes be reduced again. Along with the many other changes in Michigan's tax structure that occurred with the passage of Proposal A in 1994, the income tax rate was reduced from 4.6% to 4.4% (where it stands today). The Governor recommended that, beginning in the year 2000, the income tax rate be reduced again, over a five-year period, to 3.9%. Though the Governor's proposal was not adopted, in his 1999 State of the State address he made the same recommendation.

CONTENT

The bills would amend the Income Tax Act to reduce the State income tax from the current rate of 4.4% to 3.9% over a five-year period. The rate would be reduced by .1% each year beginning in 2000, as follows:

-- Senate Bill 1 (S-1) provides that the income tax rate would be 4.3% in 2000.
-- Senate Bill 2 provides that the income tax rate would be 4.2% in 2001.
-- Senate Bill 3 provides that the income tax rate would be 4.1% in 2002.
-- Senate Bill 4 provides that the income tax rate would be 4.0% in 2003.
-- Senate Bill 5 provides that the income tax rate would be 3.9% in 2004 and thereafter.

Further, the Act currently requires 23% of gross income tax collections before refunds to be deposited in the State School Aid Fund. Under Senate Bill 1 (S-1) (as described in **FISCAL IMPACT**, below), the revenues dedicated to the Fund would not be reduced, even though the overall tax rate was lower.

MCL 206.51 (S.B. 1)
Proposed MCL 206.51c (S.B. 2)
Proposed MCL 206.51d (S.B. 3)
Proposed MCL 206.51e (S.B. 4)
Proposed MCL 206.51f (S.B. 5)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

In the past few years, Michigan has made fundamental changes in its taxation and spending policies; overall, taxes have been reduced and spending has been restricted. This has resulted in good news for both the taxpayers and the State. After more than 25 consecutive years in which the State's unemployment rate exceeded the national unemployment rate, the State now has gone over four years with an unemployment rate below the

national average. According to the State Treasurer, Michigan was the only state in the nation to receive an upgrade in its bond rating from the three major rating agencies in the 15 months leading up to May 1998. Reducing taxes and restricting spending can be credited with drastically improving the State's economy, improving its credit rating, and letting its taxpayers retain more of their money. The bills would, over time, substantially reduce taxes, and thus would further stimulate the State's economy for years to come.

Supporting Argument

The bills would continue to erode the taxpayers' burden, thus increasing individual spending and/or saving. Over the five-year period from 2000 to 2004, the bills would result in the taxpayers' keeping approximately $3.7 billion of their money, compared with what they will pay to the State if the income tax rate remains at 4.4%. Put another way, by 2004 taxpayers would experience a total reduction in their State income tax liability of 11.4%, compared with their liability under the current income tax rate. The State has been a leader among the other states in the nation in cutting taxes in recent years, and this has had a powerful effect. While taxes were being cut, the State's economy has had continued strong growth; the State's overall employment is at an all-time high, and the unemployment rate in 1998 reached its lowest level since 1969. With lower taxes and more jobs, the State's residents have a much improved chance of obtaining a good job and retaining the money earned from it, and thus are better able to provide for the needs of their families and for the future.

Opposing Argument

While the call for a tax cut should be heeded, there may be alternatives to the Governor's proposal that would save more money for most taxpayers. One suggestion that has been made is substantially to increase the personal exemption, more than doubling it from its current level of $2,800 to $6,400, phased in over five years. Reportedly, this would save taxpayers around $3.7 billion, or the same amount of relief as proposed by the Governor; however, the distribution of the tax cut would be different. That is, a cut of .5% in the tax rate (which is what the cut would equal after the five-year phase-in) would save a taxpayer earning $100,000 a year a sum of $500, while it would save a taxpayer earning $30,000 a year a sum of $150, meaning that the person with the higher income would receive $350 more in tax relief. Expanding the personal exemption, however, would provide equal reduction in taxable income for both taxpayers, despite their income level. Also, a cut in the income tax rate would apply only to the taxpayer, while an increase in the personal exemption would apply to everyone in a household. Increasing the personal exemption, then, would be a better way to target tax relief to families, particularly those with several dependents and modest household income, and thus would put more money in the hands of the taxpayers who most need a tax break.

Response: Cutting the tax rate would be a uniform approach to reducing individual taxpayer burden; since the taxes of every taxpayer earning taxable income would be reduced, the benefits would be enjoyed by all who make tax contributions, including every family that has income. This would be the fairest possible tax cut, because it would not punish or reward taxpayers based upon the level of their incomes. The income tax started in 1967 at a rate of 2.6%, significantly lower than the final rate proposed in the bills. History has shown that tax rates, over time, tend to rise and, once risen, do not go down. Tax rates are studied closely by investors, businesses, and individuals who consider locating in Michigan. The historic reduction in the tax rate proposed in the bills would make the State even more attractive than it already is for businesses and investors that are looking for a home, and would make the State more competitive with surrounding states.

Opposing Argument

It is estimated that the tax cuts proposed in the bills would reduce revenue by $3.7 billion, a significant amount of money. If the State found itself with substantial revenue shortages, presumably it would have to make large cuts to maintain a balanced budget. The State must have enough resources to handle certain basic needs, such as protecting the public's health and safety, educating its young, incarcerating criminals, and providing a workable, efficient infrastructure. If substantial cuts had to be made because of revenue reductions caused by the bills, provision of these necessities would be placed at risk.

Response: The full impact of the tax cuts would not be felt until 2004, as they would be gradually phased in over a five-year period. Of course, it cannot be speculated as to what the State would cut in the event of a revenue shortage, because there are no budgets available for those years and no data to show how much of a shortage there would be, if any. In fact, the record shows that as the State has cut taxes in recent years, the State's economy has continued to grow and has produced more tax revenue. One thing that can be said with certainty is that the amount of income tax revenue dedicated to schools would not diminish

with the proposed tax cuts, as Senate Bill 1 (S-1) would lock in the amount of income tax sent to the School Aid Fund.

Opposing Argument

If cutting the income tax is considered desirable, then it should be done now, and at a much more accelerated pace than is proposed in the bills. The proposed .1% per year reduction amounts to $1 per $1,000 of taxable income, hardly enough for one even to notice.

Response: Cutting taxes must be done in a prudent manner so that State revenue and expenditures do not get out of balance. Further, several tax cuts just occurred in 1998, including a personal exemption increase; personal exemption inflation indexing; a college tuition tax credit; an additional child exemption; an increase in the senior interest and dividend exemption; further phase-out of the intangibles tax; and single business tax cuts. The bills offer a responsible approach to continuing tax relief, by phasing-in the tax cut over five years, thus giving the State ample time to plan. Over time, the cumulative effect of the tax cuts would provide substantial relief for taxpayers.

Legislative Analyst: G. Towne

FISCAL IMPACT

The income tax rate reductions proposed in Senate Bills 1 (S-1) to 5 would lower income tax revenue by an estimated $124 million in FY 1999-2000 and $307 million in FY 2000-01, compared with the revenue that otherwise will be generated at the current rate of 4.4%. By FY 2004-05, when the income tax rate would be at 3.9% for the entire fiscal year, income tax revenue would be reduced by an estimated $1.07 billion. The cumulative reduction in income tax revenue from FY 1999-2000 to FY 2004-05 would total an estimated $3.7 billion. This entire loss in income tax revenue would affect the General Fund/General Purpose budget.

Under current law, the School Aid Fund receives 23% of gross income tax collections and the remaining income tax revenue, after refunds, goes to the General Fund/General Purpose budget. Senate Bill 1 (S-1) is designed to hold the School Aid Fund harmless by earmarking an amount equal to what is earmarked under current law. This would be accomplished by changing the earmarking to the School Aid Fund to the gross income tax revenue generated by 1.012 percentage points of the tax rate, which is equal to 23% of the current 4.4% tax rate.

The estimated loss in revenue for FY 1999-2000 to FY 2004-05 is summarized in the following table.

Estimated Fiscal Impact of Senate Bills 1 - 5
FY 1999-2000 to FY 2004-05
(dollars in millions)

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Proposed Income Tax Rate Reduction:						
Current Law Tax Rate	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%
Proposed Income Tax Rate Reduction: *						
Incremental Reduction	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	0.0%
Cumulative Reduction	-0.1%	-0.2%	-0.3%	-0.4%	-0.5%	-0.5%
Proposed Income Tax Rate	4.3%	4.2%	4.1%	4.0%	3.9%	3.9%
Estimated Reduction in Revenue:	($124.4)	($306.6)	($506.2)	($726.4)	($966.6)	($1,070.8)
% Reduction in Income Tax Revenue	-1.9%	-4.4%	-6.9%	-9.4%	-12.0%	-12.7%
Cumulative Tax Reduction	($124.4)	($431.1)	($937.3)	($1,663.6)	($2,630.2)	($3,701.1)
Estimated Impact by Fund:						
General Fund/General Purpose	($124.4)	($306.6)	($506.2)	($726.4)	($966.6)	($1,070.8)
School Aid Fund	0.0	0.0	0.0	0.0	0.0	0.0

* Income tax rate reductions would be effective January 1 each year from 2000 to 2004.

Fiscal Analyst: J. Wortley

This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.