# Legislative Analysis

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## CAP INCOME TAX RATE IN CONSTITUTION

**House Joint Resolution T**
**Sponsor: Rep. Leon Drolet**
**Committee: Tax Policy**
**First Analysis (3-30-04)**

***BRIEF SUMMARY:*** The joint resolution would place a 3.9 percent cap on the income tax rate in the state constitution. The proposal would be put before the voters at the next general election.

***FISCAL IMPACT:*** The state income tax rate is scheduled to be reduced to 3.9 percent on July 1, 2004; therefore, this joint resolution would have no fiscal impact.

### *THE APPARENT PROBLEM:*

The agreement between Governor Granholm and the legislature reached in late December 2003 to solve a projected budget deficit for the 2003-2004 fiscal year included a six-month delay in the scheduled reduction of the income tax rate from 4.0 percent to 3.9 percent that was to occur on January 1, 2004. As a tradeoff to the delay, the legislature and the governor also agreed to exclude a portion of the payments a taxpayer makes for health benefit plans from the Single Business Tax Act. For the 2003-2004 fiscal year, the delay in the income tax rate reduction was estimated to increase state revenue by $77 million, while changes to the Single Business Tax were estimated to reduce state revenue by $2.2 million.

While the vote to pause the income tax reduction garnered well more than the minimum necessary in both chambers of the legislature, the proposal was still not without vocal critics who viewed the pause in the reduction as a tax increase. The critics argued that, given the current state of the economy, the additional $77 million should have stayed in the hands of taxpayers rather than flowed to the state. They are also concerned that while the agreement reached between the governor and the legislature pushed back the scheduled reduction for only six months, there is no guarantee that the reduction would not be delayed again to solve budget problems. Thus, legislation has been introduced that would place a cap on the income tax rate in the state constitution.

### *THE CONTENT OF THE RESOLUTION:*

The joint resolution would amend Article 9, Section 7 of the state constitution to specify that the income tax rate would not exceed 3.9 percent. The proposed constitutional amendment would be submitted to a vote of the people at the next general election

***BACKGROUND INFORMATION:***

Income Tax Rates. Following the 1999 state of the state address, the legislature passed, and Governor Engler promptly signed into law, Public Acts 2-6 of 1999 (see HB 4034, HB 4033, SB 1, SB 2, and SB 5 of 1999). The bills amended the Income Tax Act to reduce the state income tax rate from 4.4 percent to 3.9 percent beginning in 2000. Public Act 40 further reduced the rate for the 2000 tax year from 4.3 percent to 4.2 percent. The 3.9 percent rate was to have taken effect on January 1, 2004. The following is the history of the income tax rate since the inception of the tax.

| **Legislation** | **Rate (%)** | **Effective Date** |
|---|---|---|
| 1967 PA 281 | 2.60 | 10/01/67 |
| 1971 PA 76 | 3.90 | 08/01/71 |
| 1975 PA 19 | 4.60 | 05/01/75 |
| 1982 PA 155 | 5.60 | 04/10/82 |
| 1982 PA 155 | 4.60 | 10/01/82 |
| 1983 PA 15 | 6.35 | 01/01/83 |
| 1983 PA 15 | 6.10 | 01/01/04 |
| 1984 PA 221 | 5.35 | 09/01/84 |
| 1983 PA 15 | 5.10 | 11/11/85 |
| 1986 PA 16 | 4.60 | 04/01/86 |
| 1993 PA 328 | 4.40 | 05/01/94 |
| 2000 PA 40 | 4.20 | 01/01/2000 |
| 1999 PA 6 | 4.10 | 01/01/2002 |
| 1999 PA 4 | 4.00 | 01/01/2003 |
| 2003 PA 239 | 3.90 | 07/01/2004 |

Taxation and the Constitution. Article IX of the state constitution provides for the authority (and limitations on that authority) to levy taxes in the state. The only reference to the income tax is a prohibition on the state and its subdivisions from levying an income tax that is "graduated as to rate or base." Section 8 of the constitution effectively limits the rate of the sales tax to six percent. The biggest change, with respect to state and local finances, to the constitution occurred with the approval of the Headlee Amendment in the November 1978 general election. The Headlee Amendment limits state and local finances in three ways: (1) it places an overall limit on state revenue and spending, (2) it places a limit on future increases to local property taxes and requires voter approval for establishing any new local taxes, and (3) requires that the state maintain aid to local units of government at a constant proportion of total state spending and reimburse local units for state-mandated programs and services.

***ARGUMENTS:***

***For:***

Supporters of the cap believe that it is necessary to protect the pocketbooks of state taxpayers and prevent the state from balancing its budget through revenue increases rather than budget cuts without taxpayer approval. When the economy falters, households must budget and live within their means; the state should be able to do the same thing. During economic downturns, many taxpayers cannot afford the increased costs of state government pushed onto them. If a tax increase is necessary for the state to meets its obligations, then the taxpayers (the people who ultimately must support the state's obligations) should have the right to decide whether such an increase is indeed warranted.

***Against:***

Article IX, Section 1 of the state constitution states, "[t]he legislature shall impose taxes sufficient with other resources to pay the expenses of state government." A constitutional limit on the income tax rate reduces the ability of future lawmakers and governors to pay the expenses of state government and govern in the manner that they (and their constituents) deem appropriate and that they were elected to do. The rate reduction schedule was enacted premised on economic growth and budgetary surpluses projected in 1999. The problem is that economy didn't continue to grow (and actually declined) at the same pace it did in the late 1990's, and the budget surpluses never materialized. While the tax cuts may have been appropriate five years ago, some contend that continued tax cuts aren't appropriate today. Regardless of whether such tax cuts are appropriate given the current state of the economy and the state budget, the past few years have provided ample evidence that circumstances change. The legislature and the governor need the flexibility to effectively govern in changing times. If it becomes clear that an income tax increase is necessary to meet state obligations, the legislature and the governor should be afforded the opportunity to quickly resolve the state's financial problems. Raising the income tax is certainly an extraordinary act of the legislature; a decision to do so is not made without due deliberation. Legislators are not likely to make a decision without first considering its impact on and sounding out their constituents. Moreover, if the state's finances are in such poor shape that an income tax increase becomes necessary, the last thing the state needs is to wait several months for voter approval (which is no sure thing), as its problems will only get worse with time.

***Response:***

The state constitution, by its very nature, is a limit on the power of the legislature. If a constitutional cap on the income tax rate limits the ability of the legislature and the governor to increase the income tax, that is precisely what it is intended to do.

***For:***

A constitutional cap on the income tax rate provides some stability in the state's tax structure. This stability is good in the state's efforts to maintain a competitive business climate. This is particularly necessary as many businesses are incorporating as "flow-through entities" - businesses where incomes, gains, losses, deductions, and credits are not taxed to the entity itself, but rather "flow through" to the individual partner's or member's tax return, and include businesses incorporated as S corporations, partnerships, limited liability partnerships, and limited liability companies. Institutional limits on taxation demonstrate the state's commitment to lower taxes. Businesses and individuals may be wary of relocating to Michigan if it is perceived as a high tax state with high cost of living. According to committee testimony, much of the state's job growth during the 1990's can be explained by reductions in the state's tax burden. The state should strive to maintain a low tax burden, particularly since the cost of doing business in the state for reasons other than taxes is generally higher than that of other states.

***Response:***

Taxes are not the only component of the state's business climate and attractiveness to individuals. If the tradeoff to an increase in the income tax is millions of dollars in cuts, those cuts are made to a variety of other components of the state's business competitiveness and attractiveness, namely roads, schools, and local services. Furthermore, the costs of such cuts - perhaps through tuition increases or higher fees - can amount to more than the amount "saved" by taxpayers when the income tax is not increased.

***Against:***

The political realities of actually raising the income tax make a constitutional cap on the rate unnecessary. The last time the income tax was raised was in 1983. The political fallout of that increase was the recall of two Democratic State Senators which led to a change in control of the Senate. The fallout from that decision has, as commentators have noted, overshadowed every tax debate since.

***For:***

The constitution already contains a limit on the sales tax rate, an overall limit on state revenue and spending, a limit on future increases to local property taxes, and a requirement for voter approval when establishing any new local taxes. Clearly, constitutional limits on the power to tax are not unprecedented.

***Response:***

Placing a cap on the income tax rate leaves the Single Business Tax as the only tax that can be easily increased without going through extraordinary measures. The likelihood of SBT rate increasing is practically zero, as it is very much despised and slated for eventual elimination at the end of 2009. This, again, leaves the state with relatively few options to "enhance" its revenues when necessary.

***Against:***

A cap on the income tax rate severely cuts into the ability of the tax to serve as an effective and efficient source of state revenue, particularly when new credits and exemptions are added to the tax. A narrow base necessitates higher rates. The income tax could have a lower rate and raise the same amount of revenue if many of the exemptions and credits were eliminated. The state and all taxpayers would be better served if the legislature abandoned a policy of proliferating exemptions and credits that complicate the state tax form and shift tax burdens and moved instead toward lowering the rate for all taxpayers.

***POSITIONS:***

The Michigan Association of Homebuilders indicated that it supports the joint resolution. (2-4-04)

The National Federation of Independent Business, Michigan Chapter, indicated that it supports the joint resolution.

The Michigan Education Association indicated that it opposes the joint resolution. (2-4-04)

The Michigan AFL-CIO indicated that it opposes the joint resolution. (2-4-04)

The Michigan League for Human Services indicated that it opposes the joint resolution. (2-4-04)

The Michigan Federation of Teachers and School Related Personnel indicated that it opposes the joint resolution. (2-4-04)

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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.