

# Reforming Michigan's Tax System

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The foremost requirement for a tax system is that it must *raise revenue*. Over the years, the percentage of Michigan's economy that goes to taxes has decreased dramatically. For many years, state and local taxes in Michigan were slightly above the national average. But Michigan's taxes are now below the national average, and the national average has been falling.

As recently as a decade ago, state taxes in Michigan were at the limit established by the Headlee Amendment, which was added to the Michigan Constitution in the 1970s. In recent years, state taxes have fallen *far* below the Headlee limit. If the percentage of income that goes to taxes had stayed the same, the state would be collecting about *\$9 billion per year* more than it is now. The state's budget for the 2012 fiscal year is out of balance by \$1.8 billion. Thus if even one-fifth of the revenue losses of the last decade could be reversed, the 2012 budget deficit would disappear. It is popular in some circles to ascribe our budget difficulties to "runaway spending," but these numbers indicate that revenues are every bit as important as expenditures.

Tax revenues typically decline during recessions. Indeed, the Michigan economy is slightly smaller than it was a few years ago, and we would expect this to have a negative effect on tax revenues. But the shrinkage of tax revenues has been *far* larger than the shrinkage of the economy. In the last decade, after adjusting for inflation, the economy is down by a few percent, but MI's General Fund revenues are down by more than **40%**.

Dwindling revenues mean that:

- we have had to cut back our investments in early-childhood education, even though research shows that these investments earn a higher rate of return than any other.
- many of our roads are in poor repair, and many of our bridges are structurally defective.
- higher-education funding has been slashed, so that tuition has skyrocketed.
- the people of Michigan are served by fewer and fewer police officers and firefighters.

As revenues shrink, it becomes more and more difficult to provide the people of Michigan with the services they deserve.

If we want to stabilize tax revenues to provide a better future for Michigan's people, we can choose from among many possible sources of tax revenue

## Extend the Sales Tax to Services and Entertainments

In Michigan, as in most other states, the sales tax applies to the things you buy in a hardware store or clothing store, but it applies to very few services and entertainments. Services and entertainments have been growing faster than the rest of the economy for decades. Thus the sales tax applies to an ever-shrinking portion of the economy, and it contributes to our chronic fiscal crisis. The current system is also economically inefficient and unfair. If we were to extend the sales tax to all retail services and entertainments, it would bring in additional revenues of more than \$3 billion per year. By extending the tax base to services and entertainments, we could *reduce* the tax rate, and still bring in substantially *more* revenues.

Some progressives worry that extending the sales tax to services and entertainments would be regressive. This is a legitimate concern. However, many of the untaxed services and entertainments (tickets to big-time athletic events, symphony concerts, attorney's fees, accountant's fees, etc.) are disproportionately consumed by affluent people.

## Establish a Graduated Income Tax

In the last 35 years, the distribution of income has become much more unequal. Because of strong economic growth in the late seventies and through the eighties and nineties, Michigan's economy is 75 percent bigger than

it was in 1975, even after adjusting for inflation. But the bottom half of Michigan's households have not shared in this prosperity. For the bottom half of Michigan families, the standard of living has not improved appreciably in a generation. On the other hand, those at the top have done phenomenally well. Thus the ability to pay taxes is increasingly concentrated at the top of the income scale.

Despite the growing inequality, Michigan is one of only seven states with a flat-rate income tax. Most states, as well as the federal government, have a graduated income tax, under which those with higher incomes face a higher marginal tax rate. The Michigan League for Human Services has crafted a proposal for a graduated income tax, under which 90 percent of Michigan's people would get a tax cut. But because of the increasing concentration of income at the top, the proposal would still bring in additional tax revenues of \$600 million per year.

Much of the additional revenue would effectively be paid by residents of other states, because Michigan residents can deduct their state income taxes from their federal tax returns. Thus if you are in the 28-percent federal bracket, for every dollar that you pay in Michigan income tax, you get 28 cents back from the federal government. A graduated income tax is more effective in this regard than a flat-rate tax, because people with higher incomes are more likely to itemize deductions on their federal income-tax returns.

Since so much of the income growth has been at the top of the income scale, a graduated income tax would have preserved revenues more effectively than the flat-rate income tax. If we had had a graduated income tax, our budget crises would have been less severe.

A graduated income tax would require a Constitutional amendment. If it is politically impossible to get a graduated income tax, it would still be worthwhile to raise the flat rate of the current income tax. If we were to raise Michigan's rate of 4.35 percent to the five-percent rate in Utah, we would raise additional revenues of about \$1 billion per year.

### **Close Tax Loopholes**

Over the years, Michigan's tax system has been riddled with all sorts of special tax breaks for one business or industry after another. There has never been any systematic oversight of these tax breaks, many of which are very ineffective. For decades, economic research has shown that the tax system will be more efficient if it treats all industries the same. Industry-specific tax breaks should be subjected to sunset provisions.

### **Preserve the Earned Income Tax Credit**

The last 35 years have been very unkind to low-income working people in Michigan, as well as in the rest of the United States. The Earned Income Tax Credit is one of the few bright spots for the working poor. The federal EITC was established in 1975, and Michigan supplemented it in 2006. Today, Michigan's EITC is under attack, even though it is one of the most successful anti-poverty programs in American history. In the words of Ronald Reagan, the EITC is "the best anti-poverty, the best pro-family, the best job-creation measure to come out of Congress." Michigan's budget should not be balanced on the backs of the working poor. The Michigan Earned Income Tax Credit should be maintained.

### **Re-establish the Estate Tax**

Michigan used to tax the estates of the very wealthiest residents, but the estate tax was eliminated. If the estate tax were re-instituted, it would be possible to raise well over \$100 million per year, while exempting all but the very largest estates.

Many other tax reforms are possible. For more discussion, see my book *Michigan's Economic Future: A New Look* (published by the Michigan State University Press in 2010).

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