



## Tax Changes Hit Low-Income Families the Hardest

New tax changes cut business income tax revenues by 83 percent and increase individual taxes by 23 percent.

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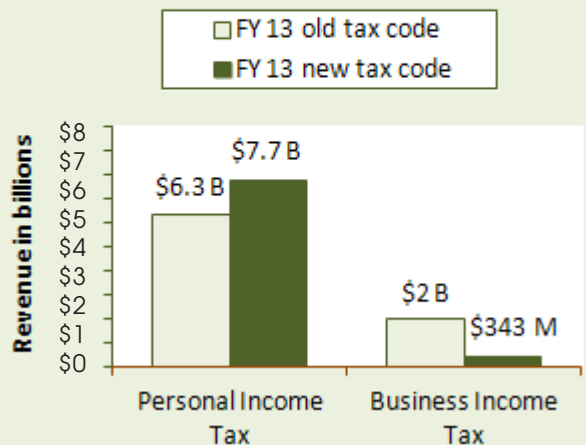
The tax package adopted by Gov. Rick Snyder and the Legislature last year will begin to take effect in 2012. Michigan’s business taxes will be reduced by \$1.6 billion, while individual income taxes will increase by \$1.4 billion, when fully implemented in Fiscal Year 13.<sup>1</sup> These tax changes make Michigan’s tax structure even more regressive. Low-income families, struggling during these difficult economic times, will be hard hit by these tax changes. This analysis examines the major tax changes, their distributional impact on low-income populations and makes tax policy recommendations.

- Honors existing MBT firm-specific credits worth an estimated \$500 million in FY 13, up from \$293 million in FY 12. The net business tax revenue will be \$343 million in FY 13.

### Overview of the Business Tax Change<sup>2</sup>

- Eliminates the Michigan Business Tax, with an estimated revenue collection of \$2 billion in FY 11, prior to the tax change.
- Levies a new 6 percent business income tax on corporations only, effective Jan. 1, 2012. This new structure will generate an estimated \$799.1 million in FY 13, when fully implemented.

### Taxes on Individuals Skyrocket as State Revenues from Businesses Dwindle



Source: Data from House Fiscal Agency  
Chart by the Michigan League for Human Services.

<sup>1</sup> “Description of Currently Enacted Personal Income Tax Changes with Taxpayer Examples,” June 8, 2011 House Fiscal Agency (HFA) memo, page 1, <http://www.house.mi.gov/hfa/PDFs/FINAL%20TaxpayerExampleM.pdf>

<sup>2</sup> “Replace MBT with Corporate Income Tax; Restructure Personal Income Tax” June 8, 2011, HFA Legislative Analysis, <http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-4361-6.pdf> and SFA “Tax Restructure”, <http://www.legislature.mi.gov/documents/2011-2012/billanalysis/Senate/pdf/2011-SFA-4361-N.pdf>

- Changes business income tax such that 95,000 businesses, or about two-thirds of all businesses, will not be required to pay.<sup>3</sup>
- Businesses benefit from an 83 percent reduction in state revenue.<sup>4</sup> Some business tax credits that were eliminated from the tax code are being restored, in part, through direct appropriations.

**Job Surge Not Likely:** The governor’s business tax cut was promoted as a way to create a better business environment, one that is more conducive to job growth. However, corporate income tax cuts are unlikely to have a positive impact on a state’s rate of economic growth or the pace at which it generates private-sector jobs, according to the Center for Budget and Policy Priorities.<sup>5</sup>

When corporations receive a tax cut, there is little or no new incentive for long-run corporate investment and so the tax cuts do not pay for themselves, according to the CBPP. Michiganians expressed a similar view about a recently proposed business tax cut in an EPIC/MRA poll. When asked what they thought business would do with the money if the Personal Property Tax was eliminated, 56 percent said they would keep it as profits or for some other use while only 26 percent said they would invest it in new equipment.<sup>6</sup>

**Job Creation Optional:** While Michigan businesses will have a significant tax cut, the new tax changes did not require Michigan businesses to create jobs or expand business investment in exchange for the tax cut. Improvements in the Michigan unemployment rate will occur as part of the expected economic recovery. But no requirements were incorporated into the tax changes for reporting new jobs or evaluating the benefit of job growth compared to the cost, independent from what would have happened without the tax reduction.

**Incentive to Opt Out of Corporate Entity:** During debate over changes to the business tax, the issue was raised that the new tax structure would create an incentive for businesses to avoid taxation by changing their entity to a non-corporation. A good tax structure makes it difficult to evade taxes. In addition, it raises

sufficient revenue to pay for government services. If a number of businesses change their entity to a noncorporation, collections will be lower than expected.

**Business Uses Public Services:** During the administration’s presentation of the tax changes, the argument was made that eliminating a business tax on incomes of about 95,000 businesses helped to address the double taxation of business income, once through the business income tax and again by the individual income tax paid by business owners. The double taxation concern is flawed because it is only applied to business and not to individuals. For example, personal income is taxed once, through the personal income tax, and again, through the sales tax on purchases. In fact, the double taxation for individuals was made worse when the recent tax changes eliminated the city income tax credit so that individuals pay taxes on the same income twice. The other argument in favor of taxing businesses is that they use government services such as police and fire services for their building, as a separate entity from individuals, and these benefits should be paid for through taxes.

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## Individual Income Tax Changes

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**Overview:** Eliminates, limits, or reduces several state individual income tax exemptions, credits or deductions in order to finance the business tax cut. Examples include reducing the state Earned Income Tax Credit from 20 percent to 6 percent of the federal credit, increasing taxes on selected types of pension income based on the age of the senior filer, and reducing the number of taxpayers qualifying for the Homestead Property Tax Credit.

**New Law Is Not Simple:** Recent tax changes were defended based on the idea that they simplified the tax structure. Simplicity means that it is easy to understand what is being taxed. It does not mean the broad elimination of tax provisions that made the tax structure more equitable for low-income families. In addition, the

<sup>3</sup> Lansing State Journal, January 2, 2012. “New state tax good for business.”

<sup>4</sup> Revenue estimates from May 2011 Consensus Revenue Estimating Conferenc, and House Fiscal Agency data October 2011.

<sup>5</sup> “Cutting State Corporate Income Taxes Is Unlikely to Create Many Jobs”, By Michael Mazerov, September 14, 2011, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3290>

<sup>6</sup> Gongwer, October 7, 2011, “Poll: Voters Might Punish Legislators For P.P.T. Repeal”

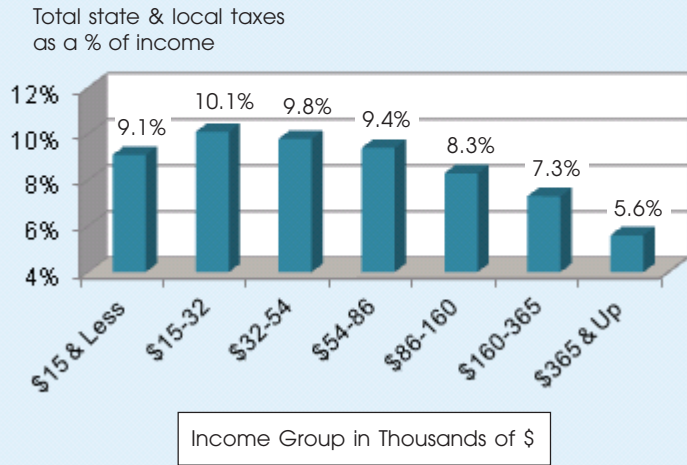
changes to senior tax preferences were anything but simple.

**Tax Changes Hinder Efficiency:** The new tax changes were justified based on the belief that the changes made the tax structure more efficient. The principle of neutrality, also called efficiency, is that tax systems favoring one kind of economic activity over another can lead to the misallocation of resources or provide preferential tax treatment. Under the tax changes, businesses providing the same good or service, but working under a noncorporation entity, will have a tax advantage over those with a taxable corporate entity.

**Outcomes Not Fair:** Taxes should be fair and based on a person's ability to pay.<sup>7</sup> Under the Michigan Constitution, the individual income tax is a flat tax rate, but other provisions have been modified over the years to include the Earned Income Tax Credit to make the flat tax more equitable. However, when the new tax law eliminated most of the credits, the state also lost the mechanism to proficiently provide tax fairness. The personal income tax had been used as a cost-effective vehicle to report and verify the family's income. Tax relief was needed because under the old law that included the 20 percent EITC, low-income families were already paying more in total state and local taxes as a percent of their income than those with higher income.<sup>8</sup> The state income tax not only collected revenue, but also did a good job of providing tax relief from other state and local taxes on sales and property. The income tax structure was doing what it was supposed to do when low-income families were provided credits to achieve fairness.

**Lost Opportunity:** An analysis by the Institute on Taxation and Economic Policy, using the prior law tax rate of 4.35 percent found that Michigan's existing tax system was regressive. The lowest 20 percent income group paid 9.1 percent of income in state and local taxes, while the top 1 percent income group paid only 5.6 percent. Low-income families pay a higher percentage of their income in state and

### Low-Income Families Were already Paying a Higher Share of Their Income in State and Local Taxes Before the 2011 Changes



Source: Data from Institute for Tax and Economic Policy  
Chart by the Michigan League for Human Services.

local taxes than do higher income families. Like all Michigan residents, they pay sales and property taxes in addition to personal income taxes. Unfortunately, however, sales taxes disproportionately affect the state's most vulnerable taxpayers, as low-income residents pay substantially more in sales tax, as a share of their income, than do higher income taxpayers. One reason is that low-income families spend most of their earnings on necessities which tend to be goods that are taxed. Higher income families spend more on services that are not taxed. Changing the state's tax structure created an opportunity to soften the blow of poverty and to provide greater economic security for low-income people. However, the enacted changes do the exact opposite.

### Key Personal Income Tax Highlights<sup>9</sup>

- State Income Tax Rate was reduced from 4.35 percent to 4.25 percent on Jan. 1, 2013 and then frozen at 4.25 percent. The annual 0.1 percent rate reduction included in the old law was repealed. The

<sup>7</sup> "ITEP guide to Fair State and Local Taxes 2011," p. 5, [http://www.itepnet.org/state\\_reports/guide2011.php](http://www.itepnet.org/state_reports/guide2011.php).

<sup>8</sup> Source of data is the Institute on Taxation and Economic Policy (ITEP), February 2011. This is a special ITEP analysis that shows the change from the old 2011 tax structure and Gov. Snyder's proposed and included the state EITC at 20%.

<sup>9</sup> FY 13 tax change revenue estimates from HFA, June 8, 2011 report.

state will gain an estimated \$223 million per year by not reducing the rate further from 4.25 percent, as originally planned.

- The personal exemption of \$3,700 will be indexed to inflation beginning in 2013. In November of last year, the Michigan Supreme Court found unconstitutional the phased out exemption for individuals with total household resources starting at \$75,000 and for joint filers starting at \$150,000. This tax increase on individuals was estimated at \$83.4 million in FY 13.
- Eliminate all other major refundable and non-refundable credits except for the Homestead Property Tax Credit and the home heating credit. This includes the elimination of the homeless shelter/food bank credits for cash donations to qualifying homeless shelters, food banks and food kitchens. Prior to the change, the nonrefundable credit was equal to 50 percent of the amount contributed, up to a maximum credit of \$100 for single and \$200 for joint returns. This credit provided \$18.8 million in 2009 to 234,100 taxpayers, for an average credit of \$80.<sup>10</sup> The elimination of this credit comes at a time when policy decisions are resulting in a reduction in the number of people receiving cash assistance and food assistance, driving up the demand on food banks and homeless shelters. Ending this credit will result in individuals paying \$23 million more in FY 13.
- The tax changes eliminated the \$2,300 exemption for seniors age 65 and older and taxpayers with unemployment insurance equal to or greater than 50 percent of their income. Ending these exemptions is estimated to increase taxes on individuals by \$41 million for FY 13.
- Child deduction was eliminated for a reduction of \$57.1 million in FY 13. It provided a \$600 subtraction from adjusted gross income for each dependent child age 18 or younger, impacting all families with children.

- In addition, major cuts were made to the Homestead Property Tax Credit and the Earned Income Tax Credit, discussed below.

## Homestead Property Tax Credit

The credit is determined based on a percentage of the property taxes that exceed 3.5 percent of income. Prior to the tax changes, the refundable credit was equal to 60 percent of the amount that property taxes (or 20% of rent) exceeded 3.5 percent of income. The credit cannot exceed \$1,200. Seniors, age 65 and up, and the disabled, received a credit equal to 100 percent of the amount that property taxes are greater than 3.5 percent of income. According to the FY 11 Tax Expenditure Report, the average 2009 Homestead Property Tax Credit was \$585.30 for general taxpayers and \$786.71 for senior taxpayers.<sup>11</sup> The table below shows the amount of property taxes, at a certain income level, a sample tax filer would have paid to qualify for the average credit. The taxpayer paid higher property taxes to their local government than was fair based on the state tax policy for that family's income. The income tax credit did what it was intended to do by providing property tax relief.

<b>Michigan Homestead Property Tax Credit, 2009</b>		
Taxpayer Examples		
Type of Taxpayer	General	Senior
Property tax paid	\$2,000	\$2,000
Income	\$29,300	\$34,645
3.5 % of Income	\$1,026	\$1,213
Taxes paid over 3.5% of income	\$975	\$787
Apply applicable percent	60%	100%
Credit	\$585	\$787

Chart by the Michigan League for Human Services.

<sup>10</sup> "Michigan Individual Income Tax 2009," Michigan Department of Treasury, published July 2011, [http://www.michigan.gov/documents/treasury/IIT\\_2009\\_359461\\_7.pdf](http://www.michigan.gov/documents/treasury/IIT_2009_359461_7.pdf), p. 3.

<sup>11</sup> "Michigan Individual Income Tax 2009," Michigan Department of Treasury, p. 24.

**New HPTC:** After the recent tax changes, fewer taxpayers will now qualify for this credit. An estimated 268,500 filers, with middle incomes from \$50,000 to \$82,650, will lose the credit. Seniors with income over \$30,000 to \$50,000 will receive a lower applicable percentage from 100 percent under the law to 60 percent under the new law. A \$270.2 million increase in taxes will be paid by individuals in FY 13.<sup>12</sup>

**Limited Eligibility:** If a low-income family qualifies for the HPTC, the credit can significantly reduce their tax burden. However, many low-income families will not qualify because they do not own or rent a home. Only about half, or 412,300, of those claiming the EITC also claim the HPTC, according to a Treasury EITC report.<sup>13</sup> To make ends meet, many of these low-income families with children are living with relatives or friends instead of renting.

**Expanded Definition of Income:** The new tax law includes a change from using “household income” to “household resources” in defining income for the purposes of the HPTC.<sup>14</sup> Household resources include all income received by all individuals in the household and excludes selected business losses. This change will impact family members that are living together because the household may contain more wage earners. While living under the same roof, these individuals are not necessarily sharing income. Yet, this greater income will be included in total household resources so that even fewer filers will qualify for the credit. The change creates a disincentive for families to help others needing shelter by taking them into their homes.

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## Earned Income Tax Credit

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**Taxing Families Into Poverty:** Five years ago, Michigan was one of just five states that taxed a working family of four making less than \$14,000, about 71 percent of

the federal poverty level, one of the harshest levels of taxation on the poor in the country.<sup>15</sup> That changed for the better when lawmakers passed the state EITC, effective in 2008. The EITC rewards earnings. The credit amount varies by family's income and number of children. The value of the EITC increases as earnings rise. The largest EITC benefits go to working families with incomes below the federal poverty line. EITC refunds help low-income families because they can use it to pay for necessities such as rent, utilities, car repairs or sales and property taxes. In addition, the refundability of the credit allows Michigan to use it as a fixed dollar state match known as Maintenance of Effort for the TANF block grant.

**FY 12 Executive Budget Recommendation:**

Eliminated the state EITC, estimated at \$338 million in 2009. In a final hour agreement, the EITC was retained at 6 percent of the federal credit at \$112.1 million, according to the House Fiscal Agency. The average payment is estimated to fall from \$432 per family at 20 percent of the federal credit<sup>16</sup> to \$143 at 6 percent of the federal credit for 782,600 filers. Taxes on low-income families were increased by \$261.6 million.

**Kids in Poverty:** The proposed elimination of the EITC ran counter to the governor's MiDashboard, which uses reducing child poverty as an indicator of the state's economic strength. It was estimated that 14,000 children would fall into poverty with the elimination of the EITC.<sup>17</sup> Although the EITC was not completely eliminated, the 70 percent reduction in the tax rate based on the federal credit will hurt low-income working families.<sup>18</sup>

The fact that the EITC was retained, even at a lower level, increases the likelihood that the tax credit could be restored in coming years. This would help low-income working people and the local economies that benefit when the EITC credits are spent.

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<sup>12</sup> HFA, June 8, 2011 report, p. 10.

<sup>13</sup> Data from Treasury, TY 2009 EITC report, p 3, published February, 2011 [http://www.michigan.gov/documents/treasury/2009EITCReport\\_345541\\_7.pdf](http://www.michigan.gov/documents/treasury/2009EITCReport_345541_7.pdf)

<sup>14</sup> HHR definition from HFA, June 8, 2011 report, p. 10.

<sup>15</sup> Taxing Families into Poverty From CBPP, “The Impact of State Income Taxes on Low-Income Families in 2010.”

<sup>16</sup> “Michigan's Individual Income Tax 2009”, Michigan Department of Treasury, July 2011, [http://www.michigan.gov/documents/treasury/IIT\\_2009\\_359461\\_7.pdf](http://www.michigan.gov/documents/treasury/IIT_2009_359461_7.pdf), p. 2.

<sup>17</sup> Taxing Families into Poverty from CBPP, “Impact of the State Income Tax on Low-income Families in 2007”, p. 14.

<sup>18</sup> The EITC tax rate was reduced from 20% to 6% of the federal credit, a cut of 70%.

## Low-Income Families and Seniors Hurt the Most

The Institute on Taxation and Economic Policy prepared a distributional analysis of Michigan's new personal income tax changes.<sup>19</sup> The analysis assumes that all tax changes have been fully phased-in including the pension changes that are being slowly phased-in by year of birth over the next few decades. Most of the other tax changes will take effect shortly after FY 12.

51% of all Michigan  
tax payers will pay  
more personal  
income taxes

The tax changes on pensions were found to be constitutional by the Michigan Supreme Court in November.

Distributional analyses of taxes show who truly benefits or is harmed by tax changes. Following are highlights from the Institute on Taxation and Economic Policy's analysis of the Michigan's tax changes. This analysis includes the estimated impact of the Michigan Supreme Court's November decision declaring unconstitutional the phase-out of the personal and pension exemptions for single filers with household resources starting at \$75,000 and for joint filers starting at \$150,000. It is clear that the regressivity of the total state and local taxes by income will become even more regressive by continuing to provide these personal exemptions for higher income filers.

**Tax Increase:** Fifty-one percent of all Michigan taxpayers will pay more in individual income taxes. Tax increases result primarily from the reduction or elimination of tax credits, exemptions and deductions to the state individual income tax. The pension tax changes are a big contributor to the tax hikes. Given the complexity of the senior tax changes, an in-depth review of specific provisions is beyond the scope of this paper.

**Token Tax Cut:** Thirty-six percent of all Michiganders will get a tax cut in their individual income tax when the law is fully implemented. The law includes a scheduled tax rate reduction from 4.35 percent in 2012 to 4.25 percent on Jan. 1, 2013, representing three quarters of FY 13. This rate cut is the primary reason that some taxpayers received a reduction in individual taxes. The cut is fairly regressive and benefits the upper income groups the most, keeping their net tax increase low. See the table below for a comparison of the tax impact based on a sample family's income.

### Higher Income Family Gains More From Tax Rate Cut

Family Income	Low	High
Income	\$17,000	\$100,000
Less personal exemption of \$3,700 (family of three)	(\$11,100)	(\$11,100)
Taxable income	\$5,900	\$88,900
Change in tax rate	(0.1%)	(0.1%)
Tax cut	(\$6)	(\$89)

Chart by the Michigan League for Human Services.

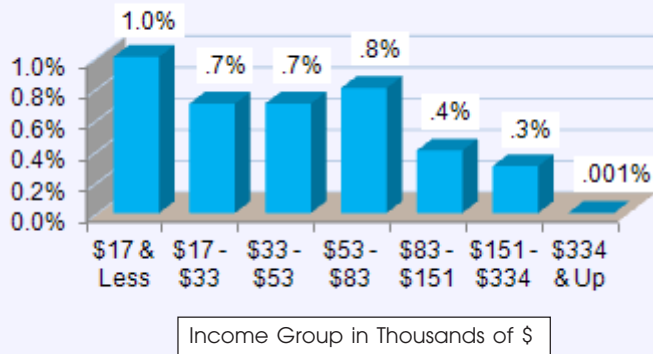
A tax cut amounting to one tenth of one percent on the rate is not going to have much of an impact on the family pocketbook. This small reduction pales by comparison to the \$1.4 billion tax increase on individuals from reducing the Homestead Property Tax Credit, the EITC, and senior tax preferences, among other changes.

**Non-Pension Income:** A few seniors will receive a tax cut. While the pension income was tax exempt under the old law, they were taxed on other types of income. Now the filer may receive a tax cut from a deduction of \$20,000 for individuals or \$40,000 for couples. However, this provision may not be as beneficial as it first appears because the new deduction cap applies to other types of income, like Social Security, which was exempt under the old tax law.

<sup>19</sup> ITEP Analysis, Institute on Taxation and Economic Policy (ITEP), May 2011, "Impact of Personal Income Tax Changes Enacted Into Law, if Fully Phased-in for Tax Year 2011, All Michiganders, 2011 income levels." Additional ITEP analysis of Michigan included at [http://www.itepnet.org/state\\_reports/povertyday.php](http://www.itepnet.org/state_reports/povertyday.php)

### Lowest Income Group Hit the Hardest by New Tax Changes

Total state & local taxes as a % of income



Source: Data from ITEP.  
Chart by the Michigan League for Human Services.

The **fourth** 20 percent income group (incomes of \$53,000 to \$83,000) will pay a slightly higher percentage of income than the two immediately preceding income groups with a 0.8 percent tax change as a percent of income. Before the Michigan Supreme Court decision that declared unconstitutional the elimination of the personal exemption for higher income groups, this income group would have paid higher taxes. They would have reached the point at which single filers begin to receive a smaller personal exemption. The phase out of the exemption began at \$75,000 of income and was eliminated at \$100,000 of income for single filers. In addition, some seniors filing a single return and reaching \$75,000 of income will lose the senior exemption of \$20,000 for those born in 1946 and later.

The next **15** percent (from \$83,000 to \$151,000) will pay an average tax increase of \$459 or 0.4 percent of their income. The next **4** percent (\$151,000 to \$334,000) income group will pay an average tax increase of \$636 or 0.3 percent of their income. The Supreme Court decision continued the \$3,700 personal exemption for single filers beginning at \$75,000 of income and joint filers beginning at \$150,000. These groups are paying a lower tax burden compared to the families with less income.

### Tax Changes by Income Group

All income groups received an average tax increase. The amount ranged from \$101 for the lowest income group to \$636 for the next to the highest income group.

The **lowest** 20 percent income group, with incomes of less than \$17,000, will pay the largest tax increase as a percent of their income, up 1 percent. This group will pay an average of \$101 more in tax liability. Taxes increased on this group due largely to the lowering of the EITC rate from 20 percent to 6 percent, and the elimination of the \$600 child deduction.

Taxpayers in the **second** 20 percent income group (incomes from \$17,000 to \$33,000) will pay an average tax increase of \$160. The **middle** 20 percent income group (incomes of \$33,000 to \$53,000) will pay an average of \$296 more. Both groups will pay 0.7 percent more as a percent of income. This middle group pays more in part because of the new provisions in the Homestead Property Tax Credit, which will be fully phased out at \$50,000.

### Average Tax Increase by Income Group



Source: Data from ITEP.  
Chart by the Michigan League for Human Services.

The **top 1 percent** income group, with incomes over \$334,000, will pay the lowest percent of their income in taxes at .001 percent. The average tax change will be \$7. Taxes were nearly the same for the top 1 percent largely due to the tax rate cut, personal exemption continuation and the fact that the taxation of pensions did not hurt them as much, as their incomes are likely to include greater nonpension sources.

Changes that tax pensions are an important factor contributing to the tax increase, especially in the mid-20 percent, fourth 20 percent, next 15 percent and next 4 percent. The bottom income groups benefit from the \$20,000/\$40,000 senior exemption. However, these upper-middle-income groups are impacted more because their pensions, dividends, interest, and capital gains are often larger than \$20,000/\$40,000 senior exemption.

### Lower State Revenues Will Also Hurt Low-Income Families

The chart above illustrates that revenue from various Michigan business income taxes has hovered near \$2 billion over the last decade. The Single Business Tax fell slightly below that level until it was eliminated and replaced by the Michigan Business Tax in 2008, when revenues rose to nearly \$2.5 billion and then declined to \$1.8 billion by FY 10. The forecast for FY 11 shows a slight upward trend, returning to \$2 billion, followed by a drop to \$1 billion in FY 12 as the MBT is phased out and the Corporate Income Tax collections begin,

although at significantly lower amounts, reaching an estimated \$799.1 million in FY 13. While a good tax structure provides for adequate revenues, business

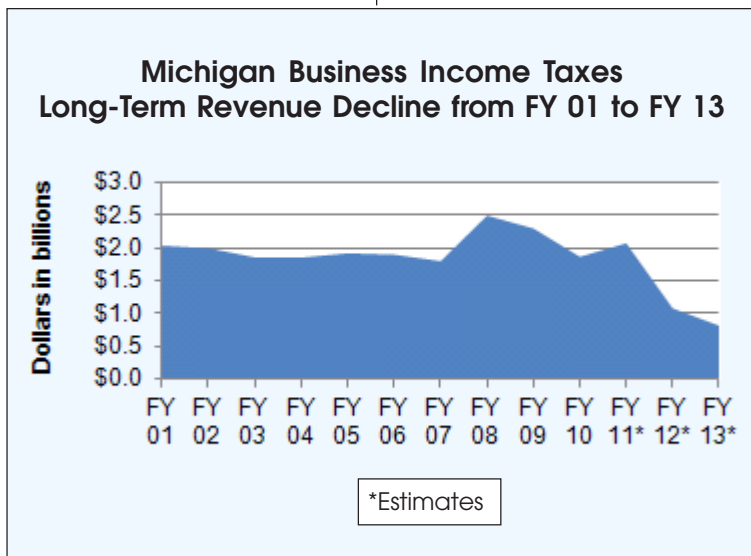
income taxes are losing ground on this measure.

**Less Revenue Less Service:** Corporate income taxes are an important source of revenue that states use to fund public services, including services essential to future economic growth like education, infrastructure, health care, and public safety. However, due to state balanced budget requirements,

state corporate income tax cuts that necessitate reductions to public services could adversely affect long-term growth.

**Tax Cut Unspent:** While low-income families spend their scarce income quickly to meet their basic needs within the local community, corporations are unlikely to spend the full amount of the tax cut in state. This fall in spending could result in a near-term drop to the stimulus of the state's economy activity.

**Safety Net Cuts:** Most of the \$1.6 billion business income tax revenue loss will be made up from policy changes to the individual income tax, estimated to increase by \$1.4 billion. Policymakers discussed the prospect of cutting business taxes to create jobs versus maintaining programs that stabilize low-income families. This replacement revenue could also have been used to fund important government structures that were cut by \$1.5 billion in FY 12. These cuts will have a negative impact on families that need a safety net during these times of ongoing economic difficulty.



Source: State of Michigan, Comprehensive Annual Financial Report<sup>20</sup>  
Chart by the Michigan League for Human Services.

<sup>20</sup> State of Michigan, Comprehensive Annual Financial Report, Fiscal Year Ended September 30, 2010. [http://www.michigan.gov/documents/budget/FY2010\\_CAFR\\_2010\\_345361\\_7.pdf](http://www.michigan.gov/documents/budget/FY2010_CAFR_2010_345361_7.pdf), p. 272. FY 11 - FY13 estimates based on May CREC forecast.



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## Recommendations for a Better Structure

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**Restore Credits:** Policymakers should restore some of the tax provisions that increased the equity of the personal income tax. These include stopping the reduction of the EITC from 20 percent to 6 percent. The reduction to the credit will not impact low-income families until they submit their tax returns in 2013 so there is time to return it to a higher level. Revenues are available through either the state rainy day fund with a balance of \$256 million or the estimated FY 11 surplus of \$457 million.<sup>21</sup>

**Graduated Income Tax:** The state could benefit from taxing other sources to make up for the revenue once provided by the business income taxes. This would help finance government services and avoid budget cuts in the future. One option is to change Michigan's income tax from a flat tax to a graduated income tax. Michigan is one of only seven states that have a flat rate individual income tax structure that taxes all residents at a single rate. In a graduated income tax structure, those with higher levels of personal income are in a higher tax bracket and are taxed at a higher rate and those with lower incomes pay a lower rate. Under such a tax structure, taxpayers in similar economic circumstances pay similar amounts of income tax.

**Flat Rate Creates Higher Burden:** Currently, Michigan taxes all personal income at a flat 4.35 percent. Under the new tax changes in P. A. 38 of 2011, this rate will decline by 0.1 percent to 4.25 percent starting on Jan. 1, 2013 and then the rate will be frozen. While everyone pays the same percentage of their income under Michigan's flat tax, that percentage represents a greater share of disposable income for low- to middle-income individuals and families and, therefore, results in a higher tax burden.

**Sales Tax on Services:** Comprehensive reform could also include a sales tax on services, modernizing Michigan's tax structure in a way that can meet the needs of a 21st century competitive state. The Michigan Legislature expanded the sales tax to services in 2007, but quickly repealed it given concerns that some services were taxed but others were exempted. Consumers' consumption patterns have been shifting from goods to services for several decades and this trend is not likely to change. Therefore, taxing some services would appear to be essential to maintaining a revenue base over the long term that could match the need for government structures.

**Low Income Sales Tax Credit:** Michigan's sales tax was increased from 4 percent to 6 percent in 1994 with passage of Proposal A. This added to the regressivity of the tax structure and the burden on low-income

households. Although the sales tax burden in Michigan is mitigated somewhat by the exemption of food and prescription medication from taxation as a result of an amendment to the state's Constitution adopted in 1974, a sales tax on some services could increase the burden on low-income taxpayers.

However, this could be remedied with a sales tax credit for low-income families, meant to offset some of the regressive burden. Expanding the sales tax to services would provide an alternative to making further spending cuts and would improve the stability and adequacy of Michigan's tax structure by raising \$1.65 billion in collections.

### TAX OPTIONS TO IMPROVE FAIRNESS

- Restore 20 percent EITC
- Adopt graduated income tax
- Extend sales tax to services
- Create a low-income sales tax credit

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<sup>21</sup> Revenue Estimating Conference, January 13, 2012.