January 2011

Fact Sheet:
Waiting for the Other Shoe to Drop?

The Case Against the Looming State Income Tax Rate Cut

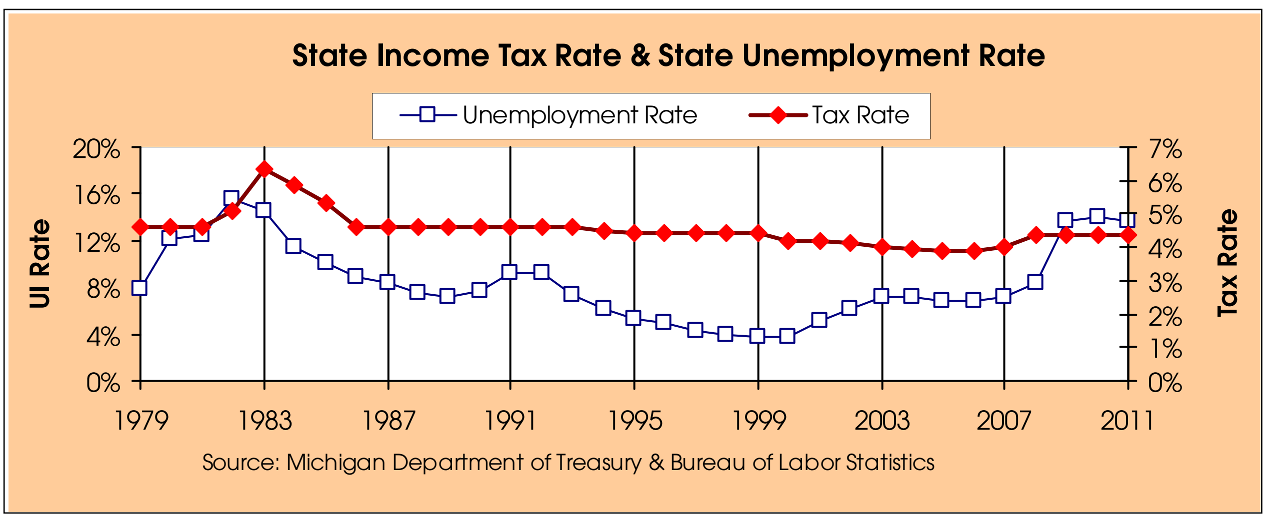
At Issue: Lawmakers and Gov. Rick Snyder could ease the fiscal year 2012 budget gap by $162 million simply by hitting the pause button on a scheduled income tax reduction that begins Oct. 1, 2011. In 2007, the Michigan Legislature temporarily raised the income tax from 3.9 percent to 4.35 percent in an effort to keep up with vital services to residents. As the state continues to wrestle with a growing need for services and reduced revenues, the other shoe will drop when the income rate begins to decline Oct. 1, further reducing state revenues.

Revenue Loss: According to the May 2009 Consensus Revenue Estimating Conference, this 2007 rate increase raised about $730 million or $162 million per 0.1 percent in tax year 2008, the first full year the increase was in effect. However, in accordance with the 2007 law, the income tax rate will be reduced by 0.1 percent each October 1, beginning in 2011, until the rate returns to 3.9 percent on or after October 1, 2015.

The upcoming tax rate reductions are estimated to reduce revenues by $162 million in FY 2012, $329 million in FY 2013 and $523 million in FY 2014, according to the Department of Treasury.

Tax Rate Varies with Economy: When the Legislature passed the income tax increase in 2007, a substitute bill was proposed that would have tied the income tax rate decline to the state's average unemployment rate and the rainy day fund. The proposal, which was not adopted, correctly recognized that putting into place a date-certain rate decline without knowing how the state's economy would rebound, was shortsighted.

The chart below compares the tax rate with the unemployment rate, which is a gauge of the economy. In 2007, Michigan's actual annualized unemployment rate was 7.1 percent, a healthier rate than the projected 2012 annualized unemployment rate of 11.5 percent, as forecast at the January 2011 Revenue Estimating Conference. With continued high unemployment a very likely



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scenario in 2011, reducing state revenues and available funds for critical public services, including lifeline programs, is not in the best interest of the state.

Over time, the state income tax rate has remained fairly stable as the unemployment rate has fluctuated up and down with the economy. However, as the unemployment rate soared in the early 1980s, state policymakers increased the state income tax rate in response. Raising the tax rate was hotly debated at the time, but it was a decision reached by conscientious policymakers in response to hard times. The income tax increase in the 1980s was not reduced until the unemployment rate significantly declined and the state's economy grew stronger. In 1994, Proposal A lowered the rate even further from 4.6 to 4.4 percent.

MBT Surcharge: The state income tax is not the only tax cut the state Legislature has enacted without knowing its full impact on future revenue gaps. Also in 2007, the Legislature created a Michigan Business Tax (MBT) surcharge in order to help close the budget gap at the time. This surcharge was enacted as a replacement for a quickly passed and quickly rescinded Sales and Use Tax expansion to various services. The MBT surcharge is scheduled to be repealed on January 1, 2017, if, during 2014, 2015, or 2016, Michigan personal income increases year-over-year.

Conclusion: Michigan's budget gaps will continue until a wide-ranging restructuring of the state's revenue system is implemented. With over 10 years of budget cutting and one-time fixes, Michigan is no closer to achieving a balanced, sustainable and equitable revenue system. Changes in the state income tax to lower the tax rate will only worsen the budget gap and further reduce funding for education, health care, infrastructure, public safety and human services programs. Long-term revenue solutions, including extending sales tax to services, implementing a graduated income tax and closing tax loopholes, are the answer, not further tax cuts.