Michigan League FOR Human Services

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Tax Expenditures: Silently Draining the State Budget

At a time when state and local revenues are plummeting and the state faces a serious structural budget deficit, the Michigan Legislature continues to pass tax expenditures that would further erode state and local revenues. Billions of dollars of tax expenditures have already been passed in just the first three months of this new legislative session. This briefing examines tax expenditures and provides recommendations on how the tax expenditure process could be improved.

What are tax expenditures?

Simply put, tax expenditures reduce or eliminate taxes that would have been otherwise paid by individuals and entities, thereby reducing tax revenues. Tax expenditures can be defined broadly as the tax revenue forgone as a result of preferential provisions such as credits, deductions, exemptions, deferrals, exclusions on lower tax rates, according to the Michigan Department of Treasury. These provisions are tax expenditures because, like appropriations, they allocate resources for specific public purposes, but do so through the tax system rather than the expenditure system. [1]

How much does Michigan "spend" on tax expenditures?

Tax expenditures are projected to increase 6.7% between fiscal year 2008 and fiscal year 2009—from $33.6 billion to $35.8 billion, according to the Michigan Department of Treasury.[2] To put that in perspective, Michigan's total state tax revenue for fiscal year 2009 is estimated to be $25.1 billion. Tax expenditures—the revenue Michigan forgoes--are growing at a faster rate than state tax revenue. Between 2005 and 2008, tax expenditures grew by about 15% compared to an 8.8% growth in total state tax revenue.[3]

Why should we be concerned about tax expenditures?

Tax expenditures:

- reduce revenues available to the state for spending;
- can grow in cost;
- are not regularly reviewed by the Legislature; and
- do not have to go through the appropriations process.

[1] Executive Budget Appendix on Tax Credits, Deductions, and Exemptions, Fiscal Year 2009.
[2] Ibid
[3] Michigan League for Human Services, May 2008.

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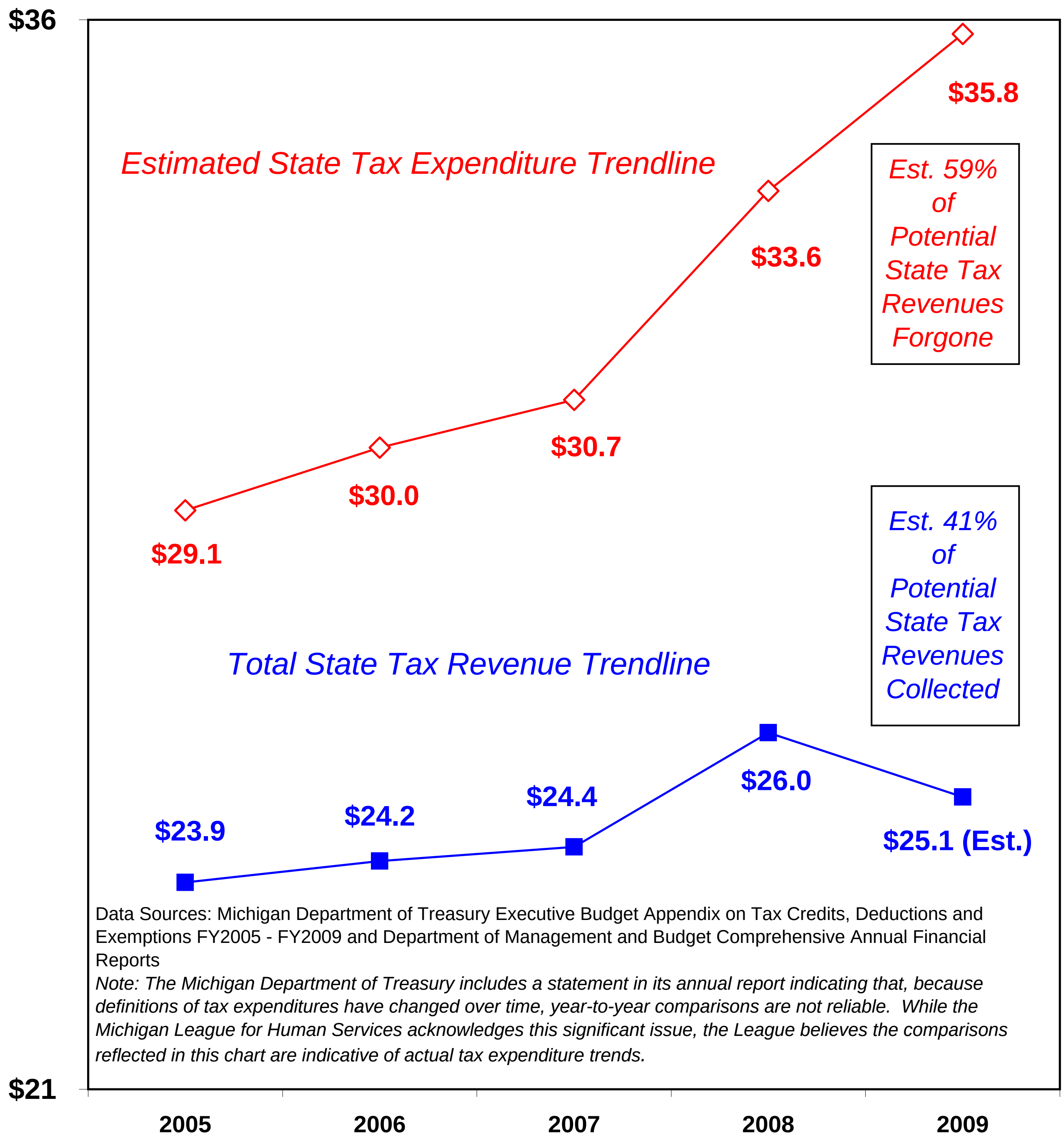
Estimated Michigan Tax Revenue and Tax Expenditure Trends

($s in Billions)



Data Sources: Michigan Department of Treasury Executive Budget Appendix on Tax Credits, Deductions and Exemptions FY2005 - FY2009 and Department of Management and Budget Comprehensive Annual Financial Reports

Note: The Michigan Department of Treasury includes a statement in its annual report indicating that, because definitions of tax expenditures have changed over time, year-to-year comparisons are not reliable. While the Michigan League for Human Services acknowledges this significant issue, the League believes the comparisons reflected in this chart are indicative of actual tax expenditure trends.

Prepared by the Michigan League for Human Services

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Like spending on specific programs, tax expenditures directly impact the state budget, but they do so in a more silent way. Some have even referred to tax expenditures as "silent spending." Particularly during difficult budget times, state spending is closely scrutinized by the governor and the Legislature. In order for any spending to occur, it must first be authorized by the Legislature and the Governor. There is no continuation funding for state programs. Tax expenditures, on the other hand, continue on without authorization, unless they are eliminated.

Over the last several years, more than $4 billion has been cut from the state budget, but few if any tax expenditures have been eliminated. When the governor and Legislature look at revenues available and line items in the budget, tax expenditures are not a part of that discussion. Essential services are being cut and eliminated while tax expenditures continue without evaluation. A list of tax expenditures is included in the Governor's budget, but unlike budget bills, the list is not debated by the Appropriations Committees.

Do tax expenditures stimulate economic development?

Defenders of tax expenditures often use the argument that such expenditures are needed in order to stimulate economic development and to create jobs. The evidence, however, suggests otherwise. According to a 2003 report for the Louisiana Department of Economic Development, tax incentives "often have no measurable impact on growth, and even when they do, it is likely that they are not cost-effective…most economists in the field would recommend economic development policy based on sufficient and appropriate infrastructure investments and service provision, and a balanced, predictable and fair tax system." [4]

Robert G. Lynch, Chairman of the Department of Economics at Washington College also says, "there are little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth." [5]

How could the tax expenditure process be improved?

The Legislature should take action to require that every tax expenditure be reviewed by the appropriate appropriations committee as part of the budget process. Rather than just allowing tax expenditures to continue without review, a decision should be required as to whether a tax expenditure continues or ends. Tax expenditures should be evaluated to determine whether they are still necessary, are meeting their goals, are cost-effective, are benefiting the public at large and are worth their cost to the state budget. Some tax expenditures are worthwhile and a good use of state money, others are not. A review system is needed to determine which is which.

As Michigan faces a serious and growing structural budget deficit, the tax expenditure process must be revised. Michigan can no longer afford to give away money it does not have.

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[4] Dave N. Norris and Elizabeth Mansager Higgins, The Impact of Economic Development Incentive Programs: A Review of the Literature, Louisiana Tech University, 2003.
[5] Robert G. Lynch, Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development, Economic Policy Institute, March 2004.