Michigan League FOR Human Services

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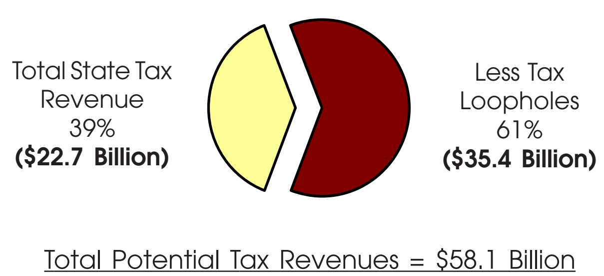
Silent and Stealthy: Michigan Gives Away $35 Billion a Year

As Michigan struggles to address yet another budget shortfall for fiscal year 2011, currently estimated at $1.7 billion, the Legislature is considering ways to balance the state budget. Of the various options being considered, one gaining some traction is to end certain tax expenditures. Tax expenditures quietly drain the state of billions of dollars in revenue every year, $35 billion in fiscal year 2009 alone, approximately four times the state's general fund budget that year.

Less Than 40 Percent of Potential State Revenue Was Collected in 2009



Sources: Michigan Department of Treasury and Michigan Department of Management and Budget.
Chart created by Michigan League for Human Services.

Ending some tax expenditures can be part of a balanced approach to closing the budget gap and would increase revenue without a general tax increase. In an effort to address the pending budget gap, lawmakers have tie-barred some of the departmental budget bills to the ending of certain tax expenditures.

Tax expenditures, often described as a type of "silent spending," come in the form of preferences such as tax deductions, exemptions, deferrals, exclusions, credits or lower tax rates given to individuals or businesses.[1] Tax expenditures are considered a form of spending as they allocate funds for specific public purposes, but do not do so through direct appropriations. They have a significant impact on state revenue as they reduce or eliminate revenue that would have otherwise been collected. These expenditures are commonly referred to as tax loopholes or incentives. Tax expenditures are divided into five categories[2]:

- individual income
- local property
- transportation
- consumption
- business privilege

The Goal of Tax Expenditures

Tax expenditures are typically used for two purposes. They are used to help redistribute the tax burden and make necessary goods more affordable for all individuals, particularly low-income individuals and families. Tax credits such as the Earned Income Tax Credit (EITC) assist low-income working families with

[1] State of Michigan, Department of Treasury. (2010). *Executive budget appendix on tax credits, deductions, and exemptions: Fiscal year 2010.* Retrieved from http://www.michigan.gov/documents/treasury/ExecBudgAppenTaxCreditsDedExemptsFY10_302899_7.pdf
[2] Ibid.

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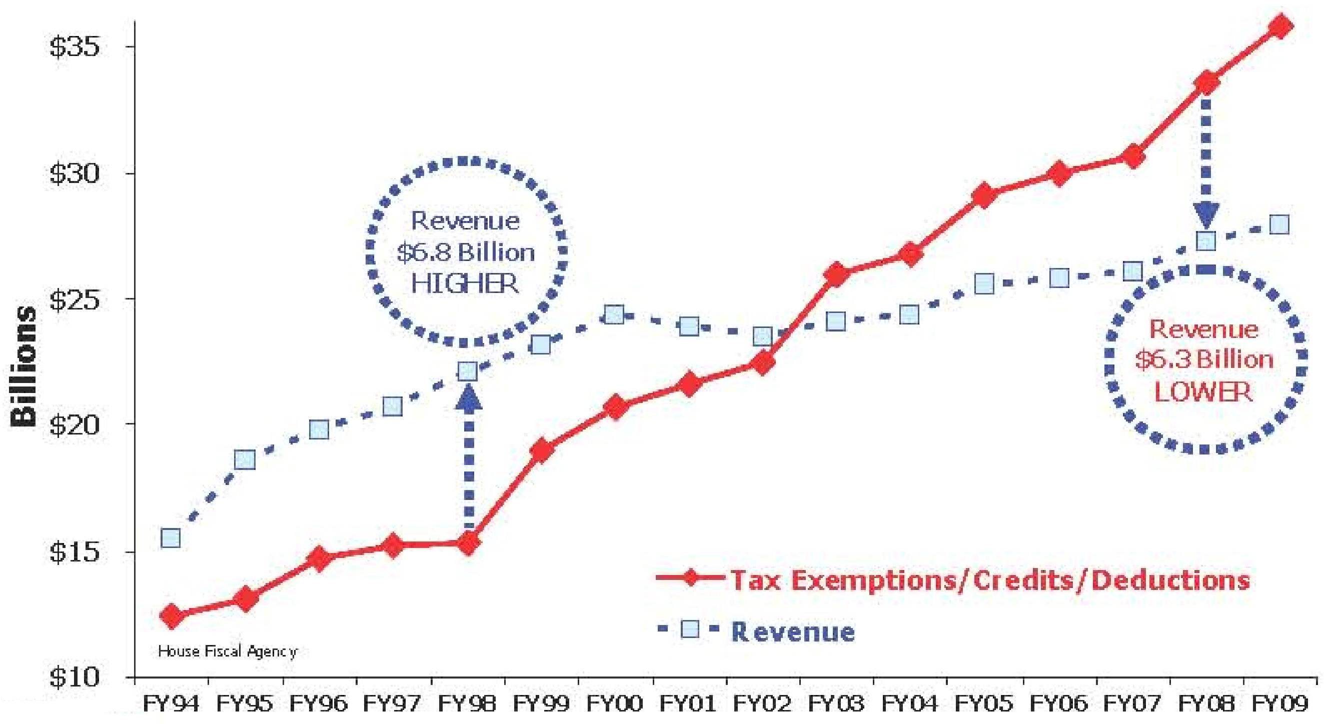
Rising Cost of Loopholes



Source: Bean, M.E. (2009, December). Michigan's revenue and budget shortfalls. Putting Michigan's fiscal house in order. Presentation to the Michigan League for Human Services' Annual Meeting and Policy Forum, Lansing, MI.

everyday needs and the Homestead Property Tax Credit helps keep housing costs affordable. Exempting food and prescription drugs from taxation also makes those items more affordable for low-income families.

The second purpose tax expenditures serve is to influence the behavior of businesses, such as giving them tax breaks if they choose to locate in a certain area, engage in environmentally friendly business practices, or create new jobs. Tax expenditures are also intended to give businesses a competitive advantage so they do not relocate out of state and take jobs with them.

Tax Expenditures and State Tax Revenue

From 2005 to 2009, when adjusted for inflation, tax expenditures grew over 10 percent and total tax revenue declined by over 13 percent. This is becoming an increasing problem for the state budget as tax revenue continues to decline, costs are continuing to rise (despite eliminating some programs and making deep cuts to existing ones), and the amount that the state gives away in deductions and exemptions continues to grow. Giving away ever increasing amounts of potential revenue each year makes an already shrinking revenue base even smaller.

Tax expenditures are projected to increase from \$35.4 billion in fiscal year 2009 to \$36.4 billion in fiscal year 2010, a 2.7 percent increase. Estimated changes for each of the five tax expenditure categories are in the following chart[3]:

[3] Ibid.

Change in Tax Expenditures (in millions)	FY 2009	Predicted FY 2010	Percent Change
Individual Income	$9,649.5	$10,156.1	5.3%
Local Property	$10,264.0	$10,193.9	-0.7%
Transportation	$47.9	$48.0	0.2%
Consumption	$13,552.3	$14,041.1	3.6%
Business Privilege	$1,901.5	$1,921.5	1.1%
Totals	**$35,415.2**	**$36,360.6**	**2.7%**

Source: State of Michigan, Department of Treasury. (2010). Executive budget appendix on tax credits, deductions, and exemptions: Fiscal year 2010.
Table created by the Michigan League for Human Services

A Process for Evaluating Tax Expenditures

There is no mechanism currently in place to evaluate the effectiveness of tax expenditures in Michigan. Unlike direct appropriations, which are part of the annual budget process, most tax expenditures are put in place and never reviewed. In addition, there is little overlap between members of the tax policy committees and appropriations committees. Without more coordination between committees that dictate income and spending, policies may be put in place by one committee that can have adverse and unintended consequences on the other.

As long ago as the early 1990s, in response to a state fiscal crisis, policymakers examined the cost of these expenditures to the state budget and realized the need to regularly review them. In 1991, a Task Force on Tax Expenditures and the Budget issued a report to the House of Representatives regarding tax expenditures and their impact on the state budget. As a part of this report, the Task Force made five recommendations regarding tax expenditures and how they should be reviewed:

Reporting

- Tax expenditure reports should be a part of every Executive Budget and expenditures should be classified by type for ease of review.

House Rules

- Bills containing tax expenditures should not be reported to the House floor without a fiscal impact analysis by the House Fiscal Agency and all tax expenditures should include a sunset provision to provide for evaluation.

Organization

- A joint subcommittee of the House Taxation Committee and the House Appropriations Committee should be established with oversight over all legislation related to tax expenditures. This committee would create a formal process for the review of all tax expenditures and end ones no longer serving their purposes.

Confidentiality of Tax Expenditures

- The House Taxation Committee should review tax confidentiality statutes in order to gain adequate information for policy analysis.

Criteria for Evaluating Tax Expenditures

- Background: what other states are doing, impact of federal laws
- Goals: objectives, what public need is being met
- Revenue Implications: costs to state and local revenues, revenue loss caps
- Best Use of Limited Resources: alternatives, support budget priorities
- Additional Considerations: are the goals accomplished, and has the targeted group benefited?

Of these five recommendations, the only one acted on was the recommendation to have a regular tax expenditure report included with each Executive Budget.

Nearly two decades later, in response to ongoing fiscal pressures, there is renewed interest in the issue of tax expenditures. In January 2010, Governor Granholm proposed moving from a one-year budget cycle to a two-year budget cycle. Tied to this was a proposal to require the review and reauthorization of each tax expenditure in the second year of the two-year budget cycle. Although no action has taken place on these proposals, lawmakers can still evaluate and end tax expenditures at any time.

A Model for Tax Expenditure Reporting

The first step in the successful evaluation of tax expenditures is a report that allows policymakers to analyze which expenditures are serving their purpose and which should be ended. In April 2009, the Washington D.C.-based Center on Budget and Policy Priorities issued a report detailing the characteristics of a high quality tax expenditure report. According to their recommendations, a state report should be[4]:

- **Accessible:** not only should the report be easy to access and use, it should actually be used to determine tax expenditure effectiveness. It should be published regularly, incorporated into the budget process and accessible online.
- **Comprehensive:** most or all tax expenditures should be included in such a report, including implicit expenditures as well.
- **Detailed:** the report should include detailed information regarding the structure and cost of each expenditure and to whom it benefits. It should include the cost to the state, a description of the expenditure (including the legal citation and the year enacted), the number and description of taxpayers benefiting, cost projections for comparison with other expenditures, and separate reporting for any expenditure that impacts both state and local revenues.
- **Analytical:** the report should detail whether the expenditure is meeting its goals and should be classified by function, state the purpose of the expenditure and include an analysis of who benefits.

Michigan is one of 42 states (including the District of Columbia) that produces a tax expenditure report and is one of the very few (if not the only one) that produces its report in conjunction with the Executive Budget recommendation. In the context of these recommendations, Michigan's report has strengths and weaknesses.

Michigan's Executive Budget Appendix on Tax Credits, Deductions, and Exemptions includes details on sales and use taxes, personal income taxes, corporate income tax, property taxes and other tax expenditures that do not fit into any of the above categories. It is also forward-looking and gives the reader the ability to see estimates for what a particular tax expenditure may cost in the fiscal year for which the report is issued.

Michigan's report also includes estimates of what most expenditures cost the state, regardless of how small. One example is the Donated Vehicle Credit, which provides a credit of up to 50 percent of the fair market value to individuals who donate vehicles to qualified organizations. In fiscal year 2010, this credit is estimated to cost the state less than $200,000. In addition, the Michigan report includes details on who benefits from certain tax expenditures (such as the Homestead Property Tax Credit), and their cost to local units of government.

The report does not, however, identify whether the tax expenditure affects the General Fund or the School Aid Fund, nor does it state the history of the expenditure, give legal citation or the year in which it was enacted. It gives no analysis as to whether the expenditure is serving its purpose, such as creating more jobs and if so, how many. The report is not as effective as it could be in helping lawmakers analyze tax expenditures.

The Future of Tax Expenditures in Michigan

Tax expenditures that are out of date with consumer habits, have little impact on job creation, or don't serve a useful public purpose could be ended, not only as a way to help balance the budget, but to create sound tax policy. Doing this would help the state better analyze how much revenue comes in versus how much is spent, (in addition to keeping or restoring programs on which Michigan residents rely). Examples of some of these expenditures include[5]:

- Exempting international telecommunication. Long-distance calls within Michigan and between states are currently taxed, whereas international

[4] Levitis, J., Johnson, N., & Koulish, J. (2009). *Promoting state budget accountability through tax expenditure reporting*. Retrieved from the Center on Budget and Policy Priorities website: http://www.cbpp.org/files/4-9-09sfp.pdf

[5] State of Michigan, Department of Treasury. (2010). *Executive budget appendix on tax credits, deductions, and exemptions: Fiscal year 2010*. Retrieved from http://www.michigan.gov/documents/treasury/ExecBudgAppenTaxCreditsDedExemptsFY10_302899_7.pdf.

calls are not. This cost taxpayers and the state $18 million in fiscal year 2009.

- Exempting the sale of food from vending machines. While food purchased in grocery stores remains exempt from the sales tax as it helps keep food affordable for people across income levels, other food that is readily consumable, such as fast food, is taxed. Not taxing ready-to-eat food from vending machines is estimated to cost the state $18.3 million in fiscal year 2010.
- Exempting a tax on a significant number of services. Michigan taxes only 26 out of a possible 168 services. Taxing so few services is out of date with consumer spending habits, as spending on services represented nearly 60 percent of personal consumption nationwide. The Michigan Department of Treasury estimates that taxing all services transactions in Michigan's economy at the current sales tax rate of 6 percent would yield over $10 billion annually. If all business-to-business, nonprofit and medical services transactions were excluded from taxation, the potential annual yield of a sales tax on services would be approximately $1.65 billion

As noted, bills to end certain tax expenditures are currently pending in the Legislature. A few examples include[6]:

- House Bill 5419 would end the tax exemption on international phone calls (as mentioned above) and would increase revenue by an estimated $15 million to $20 million
- House Bill 5490 would end the personal property tax exemption on water softeners, which would increase personal property tax revenue by just under $1.5 million, $300,000 of which would go to the School Aid Fund. The remainder would go to school districts and local units of government
- House Bill 4487 would increase the tax rate on stripper property, which is property that produces no more than 10 barrels of oil per day and on marginal oil wells that produce 20-35 barrels of crude oil per day for 12 consecutive months. Increasing this rate would increase oil and gas severance tax revenues by approximately $7.5 million per year.

If these bills and others are passed, Michigan stands to gain billions of dollars in revenue that can be used to restore vital programs and help prevent further cuts to programs, many of which have already seen significant funding reductions.

Conclusion

Michigan continues to forgo billions of dollars of revenue as the state fails to regularly evaluate the effectiveness of its tax expenditures and to end those that are ineffective or have no public benefit. With declining state revenues, another budget gap looming, and more painful cuts on the horizon, the state cannot continue to give away revenues. Part of a balanced approach to addressing the budget gap includes evaluating and ending some tax expenditures.

[6] Figures are based upon the House Fiscal Agency's legislative analyses of House Bills 5419, 5490, and 4487. Analyses may be found at http://www.michiganlegislature.org